

**MAHARANA BHUPAL  
COLLEGE,  
UDAIPUR.**

*Class No ..*

*Book No ..*

ESSENTIALS OF  
GENERAL ECONOMICS



BY  
A Gold Medallist

*Author of Essentials of Indian Economics,  
Civics, Politics, etc.*

REVISED & ENLARGED  
(Second Edition)

A. MUKHERJEE & CO.  
TWO COLLEGE SQUARE,  
CALCUTTA.

Published by  
A R Mukherjee  
2, College Square, Calcutta

SECOND (WAR) EDITION

---

Price : Rs 2/8

Printed by · S N Bhattacharya  
Tapasi Press  
30, Cornwallis Street, Calcutta

## P R E F A C E

---

The publishers make no apology for putting a new handbook on economics into the market. They feel that the book contains certain special features that will be of value to students preparing for the B.A. and B. Com. degrees.

There are two ways of writing a handbook—the first is to run through the subject systematically so that one reading the book from the first page to the last may get a thorough grasp of the subject—and the second is to discuss every possible question in the form of answers that students in the degree classes may be expected to write.

This book combines the best in both the methods. The subject is treated systematically from the fundamentals up to the most important problems, and, at the same time every discussion is in the form of answers to questions. The questions have mostly been taken from those actually set in the B.A. and B. Com. papers during the last twenty years or so, and the publishers give the assurance that no important question has been omitted.

The publishers also want to point out that a critical tone has been maintained all throughout the book. Most examinees do not realise that examiners discount answers which merely describe something uncritically or enumerate what are called 'points.' An ideal answer should give an idea of the subject under discussion, leading the examiner to realise that the student has understood the subject, and it should always be critical in the method of approach. One good argument in criticism is worth much more than half-a-dozen 'points' that merely stuff the answer with unnecessary materials.

PUBLISHER

# CONTENTS

---

| CHAPTER                                     | PAGE   |
|---|--------|
| I Scope and Definition of Economics         | 1      |
| II Fundamental Definitions                  | 16     |
| III Wants Consumption                       | 25     |
| IV Production                               | 43     |
| V Value                                     | 104    |
| VI <i>Distribution</i>                      | 141    |
| VII Money                                   | 187    |
| VIII Banking and Credit                     | 216    |
| IX International Trade and Foreign Exchange | 240    |
| X. Public Finance                           | -- 261 |
| XI State control and Socialism              | 277    |
| Appendix                                    | 269    |

---

# ESSENTIALS OF GENERAL ECONOMICS

## CHAPTER I

### Scope and Definition of Economics

Q. 1. Indicate the scope of Economics and examine the relation between economics and the science of Politics and Ethics. ( *B. Com., 1931.* )

Q. What is the subject-matter of Economics ? How is Economics related to Politics, Ethics and Sociology ? ( *B. A., 1917, 1939.* )

✓ Q. "Economics is a study of business in its social aspect". Explain and illustrate this statement. ( *B. Com., 1941* ).

It is always difficult to define exactly the scope and subject-matter of any science. A science always grows and  
Early view                      in the process of its growth its scope tends to be wider. For a long time in the past Economics was regarded just as a branch of the study of political and ethical philosophy and the restricted meaning that was attached to it was manifest in the distinction made between 'private' economy and 'political' economy. The appearance of Adam Smith's 'Wealth of Nations' in 1776 and the changed structure of productive organisation brought about by the Industrial Revolution gave the first impetus to the development of Economics as an independent science.

From the time of Adam Smith down to that of Alfred Marshall the science of Economics was regarded as a science of human welfare studied from the standpoint of material wealth. A representative expression to the prevailing idea was given by Marshall when he said, "Economics is a study of mankind in the ordinary business of life, it

conditions of material welfare of the implications of business relations that exist and grow everyday in society

In the hands of Marshall and his followers, Economics thus became a social science of business', a science studying 'business in its social aspect'. Since the Industrial Revolution, social relations had been growing complex and the explanation of the working of this complicated mechanism came to be recognised as the object of Economics.

Recently however, Lionel Robbins and others have been trying to develop Economics into a 'pure' science not practical in itself but supplying tools of rational thinking for application to practical policies. Economics thus is gradually being shaped into a scientific study of the causal connections linking our motives and our behaviours in respect of the 'attainment and use of the requisites of material well being'.

Our problems thus become more difficult. Our ends are many but our means to attain them are limited. Economics has according to Robbins, the object of studying human

behaviour in relation to the attempts to adjust our scarce means to the alternative ends that we have to attain.

We have emphasized above the 'social' nature of the science of Economics. We can perhaps conceive of a one-man society or of what we may call a "Crusoe-Economy", but it is evident that problems in such a society would be very much different from problems in our society. Economics, as we conceive it, is essentially a study of social relations.

But there are other sciences also studying various aspects of social relations. Political Science, for example, studies human relations arising from common membership of a State, i.e. relations arising from man's position as a subject, a citizen, a voter, a tax-payer, or as one capable of administering the State. Ethics studies the moral relations between one man and another. Sociology is the broad name we apply to the science that studies comprehensively the growth and development of society and the relations between different parts of society.

Economics thus is in a sense a branch of Sociology and is also intimately related to Politics and Ethics. Human society is really a whole, and not a mere aggregate of different aspects—and consequently, economic, political and ethical considerations jointly rule social life. A particular policy justifiable from purely economic considerations may have to be abandoned on account of political difficulties. Trading in opium may be very much justified from the purely economic standpoint, but ethical considerations may be appealed to for putting



a step to this trade. Economics is thus intimately bound up with Politics and Ethics and we have to recognise the truth of the statement that the Science of Economics is chiefly valuable as a handmaid of Ethics and a servant of Politics.

**Q 2** Explain carefully the limitations on the scope of Economics.

To understand clearly the extent of the scope of Economics it is best to remember the limits of the science.

*First* we have to emphasize the fact that Economics is not a complete science of society. Economics is *not a complete philosophy of society*. Social relations that constantly arise around us are subject of study not only of Economics but of other sciences like Politics and Ethics as well and in many cases economic considerations have to be subordinated to political and ethical considerations.

*Secondly*, it has to be remembered carefully that Economics is mainly concerned with answering the question

What is? and not with the question What ought to be? The latter question Economics is not normative.

cannot be answered by Economics alone, ethical and political considerations have to be taken into account when we have to decide whether we *should* impose a new tax, protect an industry, prohibit the sale of wine or enter into a trade agreement with another country.

*Thirdly* we have to note that the science of Economics explains the present structure of society, but does not

necessarily *justify* the present or any other society. We seek the truth in everything and we do not certainly stand as a defender of any particular system.

And lastly we have to remember that the laws of

Economics are very often of partial application only on account of some inherent imperfections in Economic laws the methods of reaching our conclusions. are hypothetical Human motives and the objective conditions round about us are of such variety that it is impossible to reach a hundred per cent accurate conclusion in Economics or to make a forecast about what is going to happen in future. These limits of Economics have to be kept in mind in order that we may realise the precise scope of the science we are studying.

Q. 3. Discuss the practical utility of studying Economics. (*B. A., 1934.*)

Q. "From the point of view of society's interest it is very desirable that businessmen should study Economics." Elucidate this statement. (*B. Com., 1948.*)

Though we have to emphasize strongly the limits of Economics, we should not minimise its importance. Social relations today are so complex that we Isolation of economic aspects of social problems shall not be able to comprehend them if we do not isolate economic aspects of these relations for separate study. Such isolation enables us to think clearly and understand fully the complexity of social relations. The problems arising from productive organisation, the problems regarding the proper allocation of resources among different uses, the problems of valuation and of distribution of wealth offer us fields for making important contributions.

Besides, a very important science of 'applied economics' is rapidly growing up. Every people have Management of Currency, Banking, Public Finance and foreign trade to manage their currency, their money-market, their finances and their trade with other countries. All this necessitates

practical knowledge and a thorough training in Economics is essential for acquiring the ability for running this complicated mechanism

Robbins points out that the importance of Economic Science lies in that it enables us to choose rationally between different alternatives. We often aim simultaneously at ends that are mutually incompatible—we want for example that our incomes should rise and that at the same time prices should fall. Economics teaches us that these ends are mutually contradictory—one cannot be had if the other has also to be secured. Economics says Robbins provides a technique of rational action and makes it possible to act consistently in choosing our ends and our means for attaining them.

**Q 4** Discuss the claims of Economics to be regarded as a Science. (B A 1933)

A science is a systematic study of observed facts with a view to establishing general conclusions which in their turn can be applied for attaining practical ends. It is in this sense that Physics Chemistry Mathematics or Botany can be regarded as sciences. In Physics we study matter and try to discover certain general laws regarding matter. We follow the same process when we study plants or the relations between numbers.

The first essential of a science is that there must exist a good degree of homogeneity in the phenomena studied so that general conclusions may be possible. Besides for the study of every quantitative science it is necessary to have a uniform standard of measurement. The physicist

has a standard of measurement for each category he studies, namely, distance, time, weight, pressure, work etc.

It has often been argued that Economics cannot properly be called a science because there is no homogeneity in human motives and behaviour. It is pointed out that no two men are identical in mental make-up and that the impulses and motives that set one man in action may fail to do so in the case of another. Besides, it is argued that our life to-day is a complicated maze of known factors and unknown factors and that it is impossible to find out universal truths or laws of causation out of this jig-saw.

We can, however, point out that in spite of the wide varieties of individual motives and activities, there are certain common tendencies visible in every mind. Had it not been so, it would not have been possible to develop the science of Psychology. The common psychological propensities of men lead them to uniform or nearly uniform behaviour and these serve as the bases upon which we build up our science of Economics. The elementary fact that the consumption of a large quantity of any article would diminish the desire for that article is based on a common psychological trait of the human mind, and this elementary fact, under the name of the law of diminishing utility, is one of the basic principles of Economics.

Instances can be multiplied and it can be shown that the law of demand, the concept of consumer's surplus, the laws regarding substitution and preferences—all depend on certain universally discernible psychological uniformities, and these uniformities give Economics the character of a Science.

We require also a measuring rod and here we know money serves us fairly well. Money has a number of imperfections as a measuring rod but yet we can have a serviceable standard of measurement and of comparison if we try to gauge the strength of human motives and desires by the amount of money received or paid.

Economics thus has all the characteristics of a science and like other sciences it proceeds towards its conclusions by the inductive method and develops itself further by the deductive method.

✓ Q 5 There is not any one method which can properly be called the method of Economics but every method must be made serviceable in its proper place. Explain (B Com, 1933 B A 1934)

Q Bring out carefully the advantages and disadvantages of the various methods for the study of Economics (B A 1934)

The study of a science involves first, the establishment of general conclusions and secondly the application of these general conclusions to particular cases with a view to acquiring further knowledge. For the first purpose the only method available is to observe carefully the facts to be studied. If it is impossible to observe all the facts a sufficient number have got to be considered. From these observations it will be possible to discover certain uniformities and these

Methods of Science

Inductive method

will serve as *hypotheses* or provisional conclusions. Then these have to be *verified* by further observation and *experiment*, and when the verification has been successful we can establish the law. This method is the only method of reaching the basic laws of science and is known as the *Inductive method*. The other method—that of proceeding to particular cases from general propositions—is known as the *Deductive method*.

In Economics both of these methods are absolutely essential—the inductive method for establishing basic conclusions like the law of diminishing utility, the law of diminishing returns, the law of the growth of population, the law of the relation between money and prices

etc.,—and the deductive method for building up the extensive ramifications of the science into the field of demand or value or distribution. The laws of value are nothing but deductions from the general propositions we establish regarding utility on the one side and the returns to effort on the other. No science can do without both of these methods and Economics is no exception to the general rule.

Earlier Economists, however, often began at the wrong end by making the deductive method their basic method.

A deductive approach requires some already known general principle and this the earlier Economists (e.g. Adam Smith, and even Ricardo) obtained by making certain assumptions about human nature. From these assumptions conclusions were drawn by the methods of deduction, and

it may be easily realised that these Economists often moved very far away from reality

The first approach towards a scientific study of Economics was made by the 'Historical School' of Germany The

The Historical school      historical method is practically the inductive method minus its logical refinements

At the present day we find that there is practically no dispute about the methodology of Economics We attach importance to both the inductive as well as the deductive methods and we give to each its proper place in our studies

Q 6 Comment on the following—'Economic laws are essentially hypothetical' ( B A , 1931 )

Q Examine the statement that the laws of Economics are to be compared with the laws of tides rather than with simple and exact law of gravitation" ( B A , 1926 )

Every science has got to establish certain laws of causal connection between the different phenomena it studies

The term law      These laws are not laws in the sense in which the word is used when we speak of moral laws or of the civil or criminal laws The term 'law' when applied to a science means a statement of a causal connection between one thing and another It is in this sense that the law of gravitation the law of inertia and the law of diminishing utility are scientific laws

A law can be established only when (a) a sufficient number of cases have been observed, (b) a provisional conclusion drawn, and (c) the conclusion verified by experiment An economic law should involve all these three processes in

Process of establishing a law

order to attain the accuracy of a law of Mathematics or Physics. But it is apparent that while we are free to observe and to frame hypotheses, it is not possible for us to carry out controlled experiments for verifying our provisional conclusions. The Economist has no laboratory where he can reproduce under controlled conditions the phenomena he wants to study. He has, therefore, to depend only on observation and consequently his conclusions are liable to be vitiated by the defects inherent in observation.

Economic laws, being dependent mainly on observation, are thus rendered essentially hypothetical by the possibility that our observation may be wrong (*mal-observation*) and that we may miss much when observing (*non-observation*). Our conclusions are correct in so far as they

depend on factors that can be seen and comprehended; they are liable to be incorrect in so far as they depend on 'hidden' factors, factors that cannot be readily seen, isolated and understood. In this respect the laws

of Economics can be compared with the laws of the tides. Tides depend on the solar and lunar attractions and as it is possible to calculate these, it seems to be possible to forecast when a flowtide will take place. But tides also depend upon the constantly changing weather conditions and in so far as this is so, the forecast is likely to be inaccurate. It was because of this that Marshall said that the laws of Economics should be compared with the laws of the tides rather than the simple and exact law of gravitation.



The law of diminishing utility and the law of demand, for example are fairly universal laws, but even these are illustrations ✓ not hundred per cent universal. Human motives, time, circumstances etc may fluctuate and hence conclusions true under one set of circumstances may not hold good in another. A fall in price will generally lead to an increase in demand, but a fall in price during the downward phase of a trade cycle or at a time when fashion is showing a swing-off may not be accompanied by a rise in demand. We cannot claim universal validity for the laws of Economics and we have to recognise that these laws always retain their hypothetical character.

**Q 7 Explain the meaning of the term 'Normal'**

The term 'normal' in Economics means what is likely under a given set of circumstances, and is, therefore an adjective from the term 'law' used in the expression 'economic law'. The term 'normal', it should be remembered, refers only to the probable result of a given cause and says nothing about the rightness or the wrongness of the result. A study of what is normal is a dispassionate study of causes and effects.

**Q 8 Discuss the influence of competition on modern industry and trade (B Com, 1927)**

**Q Discuss the merits of competition in the economic sphere and indicate some of its incidental defects (B Com, 1938)**

**Q "Competition is neither wholly good nor wholly bad" Amplify (B A, 1926)**

✓ **Q "Competition secures for society the elimination from industry of incompetent or dishonest entrepreneurs and the survival of the fittest" (B Com, 1945)**

One of the characteristic features of the economic system of our times is found in what is known as competition. By competition we mean a system under which nothing is predetermined by status and custom, and everything is determined by the free play of the forces of demand and supply. Competition is the economic consequence to which the political policy of *laissez faire* is expected to lead, and we find a biological counter-part in the struggle for existence among animal organisms leading to the survival of the fittest.

The biological counter-part of competition has led to the generally accepted idea that competition secures the maximum of satisfaction under all circumstances. It is pointed out that competition makes the producer efficient and the buyer watchful and that ultimately competition leads to a state of affairs that satisfies everybody. Besides, it is pointed out that competition implying a negation of monopoly is beneficial to the consumer as it is able to secure low prices for him. And lastly, it may be argued that competition has evolved a system of economic life where the mutual interdependence of men is very markedly emphasized.

On the other side, however, it may be pointed out that the struggle for existence and the mutual tussle that competition brings in do not always benefit society. Those who survive the struggle are not always those whose survival is most desirable from the standpoint of social welfare; instead of being those who are best able to *benefit society*, they are very often those who are best able to *derive benefit from society*. The capitalist

in his struggle with the other members of society or the employer in his struggle with the employees always creates a situation that benefits the strong and makes the weak suffer. It is puerile logic to argue that maximum welfare will be obtained when each is trying to minimise other people's welfare.

Besides competition and monopoly are not mutually contradictory, they are rather *antithetic* in the sense that though monopoly means the opposite of competition yet monopoly very often is the inevitable consequence of competition. The vast combinations of the trusts and the syndicates are the natural results of uncontrolled competition.

Moreover, we find that it is uncontrolled competition that is responsible for the much dreaded industrial fluctuations.

Competition in production leads to waste and undisposable surplus, competition in trading to rate cutting and unremunerative sales and competition in credit expansion to money market booms.

We find, therefore, that on the one side competition has evolved an economic system that is almost automatic in its operation, a system that works without regulation in a fairly efficient manner, and that under it the producer is made keen, alert and technically efficient. On the other side much of the evils of the present day world over production and crises, mal distribution of wealth, monopolisation in industry and the like have been brought about by the same competitive regime.

Competition is thus neither wholly good nor wholly bad.

If it is possible to retain the advantages of competition and to eliminate its disadvantages, society would benefit much. All the modern trend towards control and regulation, planning, and ultimately socialism, is a reaction against free competition.

Q. 9. What is meant by freedom of enterprise ? Discuss the influence of economic freedom on production.

( B. A. , 1924 )

The term 'competition', it has been pointed out by Marshall, means a condition where there is no restriction of individual freedom in so far as this does not bring about any direct injury to others. But somehow or other the term 'competition' has come to gather an evil savour round about it, implying that every one in the community is at an economic war with everybody else. It is because of this that Marshall suggests the use of the term Freedom of Industry and Enterprise or, more shortly, Economic Freedom.

This Economic Freedom implies freedom of movement from one place to another, freedom of choosing one's own occupation, freedom of deciding one's own articles and methods of consumption, freedom of combining with others and freedom of carrying on production and trade. In a word, economic freedom means absence of control wherever control can be dispensed with.

[ For the effects of Economic freedom or competition on production see answer to Q. 8, ]

Q. 10. Show that everybody in our present economic society stands in two relations to other members of society :

(a) in a relation of conflicting interest and (b) in a relation of common interest ( *B Com 1941* )

The scarcity of resources in our society enhances the keenness of competition. Resources are acquired by some at the expense of others and this brings in a conflict of interest throughout society. This conflict of interests is apparent almost everywhere—in the relations between buyers and sellers between employers and employees, between one employer and another between one employee and another between landlords and tenants and so on. It seems that in our society no one can secure his own interests except at the expense of somebody else.

All this however is more apparent than real and to the extent these are real they are due to the nature of society we live in and not to the essential nature of things. A little reflection shows that there should not be any conflict of interest between producers and consumers because production makes consumption possible and consumption makes production profitable. This is true about practically everything else. It is the individualist profit hunting motive that makes every relation a conflicting one but in spite of this an unconscious co-operation among all factors and owners of factors is discernible. In a society where economic planning for the general good is undertaken the real unity of interest stands emphasized *in preference to the* apparent conflict of interests.

---

## CHAPTER II

### Fundamental Definitions

Q. 1. Examine the characteristics of Wealth. Discuss whether the following ought to be regarded as Wealth : (a) fresh air, (b) the copy-right of a book, (c) intoxicating liquors, (d) dexterity of a mechanic. ( *B. A., 1927.* )

It is usual to recognise Economics as a Science of Wealth, though Marshall has emphasised that the main subject-matter of Economics consists in *human activities* in respect of earning and spending wealth. In any case wealth remains the central objective of all economic pursuits and the Economist has to begin his study by attempting a precise definition of 'Wealth'.

We give the name "goods" to all desirable things, *i.e.* to all things capable of satisfying a human want, or, in short, to all things possessing 'utility'. Among Goods goods there are some that are available in unlimited quantities and thus their attainment and use do not give rise to any social problem. Most goods are, however, scarce relatively to the demand for them and we give the name of "*economic goods*" to these. These scarce goods can further be divided into goods that are *internal* to man and hence not transferable ( *e.g.* virtues and vices ) and goods that are *external* to man. These external goods can either be *transferable* or *non-transferable*. It is to be remembered that non-material goods may also come under the class of

external goods, instances are found in the copy-right of a book or the goodwill of a business

|                           |   |
|---------------------------|---|
| Classification of goods   | Wealth consists of two classes of goods (a) goods that are <i>material, external, scarce and transferable</i> , and (b) goods that are <i>non-material external, scarce and transferable</i> . Taking the common features from these we get the following characteristics of Wealth. Anything <i>material</i> or <i>non-material</i> can be regarded as Wealth if it is (1) external to man, (2) limited in quantity, & <i>e</i> scarce in relation to demand, (3) transferable from one person to another, & <i>e</i> capable of being bought and sold, and (4) capable of satisfying a human want |
| Characteristics of Wealth |   |

|                       |  |
|-----------------------|--|
| Examples<br>Fresh air | Applying these standards we can easily find out whether a particular thing is Wealth or not. <i>Fresh air</i> is not ordinarily scarce and is not, therefore, Wealth. If in special circumstances, <i>e g</i> in an underground structure, fresh air is scarce, it becomes Wealth. The copy-right of a book, though non-material, satisfies all the characteristics laid down and is therefore Wealth. <i>Intoxicating liquor</i> also satisfies all the four characteristics. It may be argued that it should not be regarded as Wealth on account of its injurious nature, but it has to be remembered that the Economist has to do with the <i>fact</i> of want-satisfaction and not with the <i>ethics</i> of want satisfaction. Wine may be a harmful article but so long as it <i>really</i> satisfies a real want, it must be taken to possess utility. The <i>dexterity</i> of a mechanic is not Wealth because it is neither external nor transferable. |
| Copyright             |  |
| Wine                  |  |

Q. 2. Which of the following will you call Wealth ? Give your reasons in each case : (a) a gold coin, (b) gold ore in a mine, (c) gold in the planet Mars, (d) an autograph of Rabindranath, (e) a healthful climate, (f) executive ability, (g) a farm the ownership of which is under dispute, (h) a B.A. diploma obtained by a graduate. ( *B. A., 1942.* )

Anything material or non-material can be regarded as Wealth if it is (a) capable of satisfying a human want, (2) scarce in relation to demand, (3) external to man, and (4) transferable from one person to another. We can apply these tests to the given instances and easily determine which of these can be regarded as Wealth.

(a) A gold coin can satisfy human wants through its exchange-value and can also yield the pleasure of possession. It is also scarce, external and transferable and, therefore, it can surely be regarded as Wealth.

(b) Gold ore in an undiscovered mine is of no use to any one. But gold ore in a mine that is being worked satisfies all the characteristics of Wealth. Even when the gold has not actually been mined out, it can be sold on the basis of estimated stocks. The other characteristics—namely, scarcity, external character and possession of utility—are also clearly present.

(c) Gold in Mars is not available for human use and is not transferable from one man to another. It cannot be regarded as Wealth.

(d) Tagore's autograph gives a high degree of satisfaction to collectors. Supplies of such autographs are not unlimited and an autograph collected by one can be sold to another. It can, therefore, be regarded as Wealth.



(e) A healthful climate cannot be transferred from one person to another and hence it is not Wealth in the sense in which we use the term in Economics

(f) Executive ability is a personal quality and is therefore internal and non transferable. Wealth must be external to man and therefore executive ability though regarded by some as personal wealth cannot strictly be called Wealth

(g) A farm the ownership of which is under dispute possesses utility and is external and scarce. It cannot of course, be transferred so long as the dispute is not settled by a court but this is only a temporary difficulty. Besides, our criterion is not whether the thing is being transferred but whether it is transferable. It is possible therefore to regard a farm like this as Wealth

(h) A B.A. diploma can be used only by the person who earns it. It cannot be transferred so as to confer the degree to the new purchaser. It is not therefore, Wealth. One can however argue that a B.A. diploma is Wealth to the extent of the value of the piece of parchment on which it is printed

Q 3 Explain briefly the meaning of the terms Utility, Value and Price

By Utility we mean the power which a commodity has got of satisfying a human want. As Economists we do not inquire into the desirableness or undesirableness of a commodity we merely ask if it is *desired in fact* or not. So long as a commodity is really desired it is taken as having Utility however *undesirable* may be the consumption of the article

The word Value has sometimes been used to mean *Value*

*in-use*, i.e. the satisfaction yielded by a particular commodity to the person using it, and sometimes again to mean *Value-in-exchange*, i.e. the power which a commodity has got of commanding other things in exchange. In order to avoid ambiguity, we use the word 'Utility' to stand for the sense conveyed by 'Value-in-use' and we use the word 'Value' only to mean 'Value-in-exchange'.

The Value-in-exchange of a commodity can be expressed in terms of any other commodity. But if every value has to be measured in terms of every commodity, numerous difficulties would arise. We, therefore, usually measure Value-in-exchange in terms of a common denominator, viz. money. Value-in exchange expressed in terms of money is called 'Price'.

Q. 4. 'An increase of wealth is not necessarily synonymous with an increase of welfare'. Discuss this statement. (*B. Com., 1939.*)

✓ Q. Define Wealth and discuss the relation between Wealth and welfare. (*B. A., 1930.*)

The way in which Wealth is defined in works of Economics makes it clear that Wealth and welfare, though intimately related, are not exactly synonymous. When we use the word 'Wealth' we generally refer to some *product* of human labour, satisfying certain characteristics. The term 'welfare' is abstract and stands for the well-being that an individual or society enjoys. It is, however, apparent that Wealth is a means to welfare, because the possession of some Wealth is the indispensable condition of human existence and because an addition to Wealth above that indispensable

minimum generally increases freedom. An increase in Wealth usually but not invariably means an increase in welfare.

But if we want to make Wealth a perfect indicator of welfare we fail. When we speak of Wealth we do not distinguish between things giving the desirable kind of satisfaction and those that give satisfaction of an undesirable type. Wealth—not a perfect index of welfare but this distinction is vital in considering the welfare or well being of an individual or a society. Secondly Wealth measures satisfaction only in terms of market values but it is well known that market values are the results of some objective conditions and they bear little connection with the absolute value of a commodity or with its capacity to add to well being.

It is also to be remembered that the amount of welfare that a given quantity of Wealth brings may be very largely affected by the way in which the total wealth is distributed among the individuals. Welfare depends on distribution. The inequalities of Wealth reduce economic welfare not only because of the fact that the satisfaction of the rich does not compensate for the dissatisfaction of the poor but also because a few wealthy persons set up a standard of tastes and fashions which the poor try to emulate unsuccessfully thus adding to their miseries the pain of failure and disappointment. The riches of the rich intensify the poverty of the poor.

Welfare is thus affected by the manner in which Wealth is earned the manner in which wealth is consumed the manner in which it is distributed and lastly the manner in which it is valued. While Wealth can usually be expected

to imply welfare, any change in the manner of earning, distribution, consumption or valuation will affect welfare even when the total volume of Wealth is not changed.

Q. <sup>15</sup> E. Explain the meaning of, and the relation between, Production and Consumption. ( *B. A., 1926, 1924.* )

There had been in the past a good deal of discussion regarding the meaning of the term 'Production' and the distinction between productive and unproductive labour.

|                             |   |
|-----------------------------|---|
| The Mercantilist view       | The Mercantilists of the 15th. and 16th. centuries regarded labour devoted to developing export industries only as productive. The Physiocrats, who developed into an important school in France in the 18th. century, confined the name 'Production' to the turning out of agricultural products, as they regarded all other labour as only giving |
| The view of the Physiocrats | changed shapes and forms to things already existent. Adam Smith improved the definition of the term 'Production' by regarding as productive any labour yielding some  |
| Adam Smith                  | material or tangible product.   |

|                                |  |
|--------------------------------|--|
| Present-day view               | Even this definition was incomplete as it would keep out of the scope of the term 'productive labour' a large number of persons like lawyers, doctors, teachers, judges, ministers, civil servants, actors, domestic servants, etc. At the   |
| Form, Place and Time utilities | present day, the generally accepted view is that any labour or effort that yields utilities is productive, 'since the essence of Production is that it leads to satisfactions or utilities.' Labour is thus to be regarded as productive whenever Utility is created, whether by giving new form to things already |

existing or by transporting a thing from one place to another, or by stocking it over time. *Production means any effort or labour, either of the body or of the mind, resulting in satisfying some social want*

'Consumption' is the reverse process of Production. If Production means addition of Utility, Consumption means a process slow or rapid, of elimination of Utility. When a commodity has been fully consumed, it ceases to have any further want satisfying power. Consumption thus destroys Utility and creates the necessity for further Production.

This explains the relation between Production and Consumption. Production creates Utility and makes Consumption possible, Consumption destroys Utility and makes Production necessary. There is thus a circularity of relation between the two, one leading inevitably to the other.

Marshall points out another aspect of this circularity in the relation between Production and Consumption. In the early stages of human society wants gave rise to activities i.e. the need for Consumption gave rise to the need for Production. As civilisation grew, each activity came forward to give rise to new wants and thus steps towards Production came to cause new demand for Consumption. In some cases, Production comes through scientific inventions and then through advertisement campaigns the products are made popular and a want for these is deliberately generated in the mind of the people. The producer nowadays often creates the want which he seeks to satisfy

---

## CHAPTER III

### Wants : Consumption

*Q. 1.* Explain the main characteristics of human wants.

The characteristics of human wants are broadly divisible into five categories. *First*, human wants as a whole are progressive in nature. The more we try to satisfy our wants, the more we experience the growth of new wants. *Secondly*, human wants are various in kind and countless in number. *Thirdly*, there are some wants which can be satisfied by any one of a number of alternative commodities. The want for a morning beverage can, for example, be satisfied by tea, or coffee, or cocoa. *Fourthly*, there are some wants which can be satisfied only by two or more commodities jointly consumed, e.g. a motor car and petrol. *Lastly*, the most important characteristic of human wants is that, while wants as a whole can never be completely satisfied, each particular want is satiable, provided a sufficient quantity of the commodity required is available. From this follows the principle of satiable wants which is given a scientific form under the name of the Law of Diminishing Utility.

Q 2. Explain clearly the distinction between Total Utility and Marginal Utility and show that market value coincides with Marginal Utility ( *B Com 1937, B A. 1930 1925* )

The distinction between Total Utility and Marginal Utility is fundamental in all analysis of Consumption. The meaning of the term Total Utility is self evident, it means the aggregate amount of the satisfaction obtained from the consumption of given number of units of a particular commodity. The term Marginal Utility is used to denote the additional Utility obtainable from the consumption of an additional unit of the commodity or what comes practically to the same thing the loss of Utility that would result if one unit less were consumed. On account of the operation of the Law of Diminishing Utility Marginal Utility gradually goes on decreasing while Total Utility goes on increasing at a diminishing rate. An example perhaps will make the concepts clear.

| No of Oranges consumed | Sat sfaction derived from the last one measured in money | Total satisfaction measured in money |
|------------------------|--|--------------------------------------|
| 1                      | 4 as   | 4 as                                 |
| 2                      | 3 as   | 7 as                                 |
| 3                      | 2 as 6 p   | 9 as 6 p                             |
| 4                      | 2 as   | 11 as 6 p                            |
| 5                      | 1 a. 6 p   | 13 as                                |
| 6                      | 1 a  | 14 as                                |

Thus the Total Utility increases from 4 as to 7 as and then to 9 as 6 p. this obviously is an increase at a decreasing rate. The Marginal Utility is evidently falling gradually

The price of a commodity ultimately comes to be equal to the Marginal Utility. If the price be higher than the Marginal Utility, it will be unprofitable to buy the last few doses and this curtailment of purchase will raise the Marginal Utility until it comes to be equal to the price. On the other side, if the Marginal Utility be higher than the price, further purchase will be profitable and hence Marginal Utility will fall and ultimately price and Marginal Utility would be equal to one another.

Q. 3 Explain clearly the Law of Diminishing Utility, examining the supposed exceptions to the law.

The Law of Diminishing Utility is based on the elementary psychological fact that the desire for a commodity gradually declines with every increase in the quantity secured. This law of diminishing desire can be stated more accurately as follows : the additional benefit which a person derives from a given increase of his stock of a thing diminishes with every increase in the stock that he already has.

The example we have given in explaining the distinction between Total Utility and Marginal Utility can be used here.

With every increase in consumption, the urgency of the want for the commodity diminishes and hence each additional dose brings less satisfaction than the previous one. As has already been shown, it is Marginal Utility that decreases, while Total Utility increases at a decreasing rate. The law should, therefore, be properly called the Law of Diminishing Marginal Utility.



It is however to be remembered that the Law of Diminishing Utility operates only when consumable units of the same commodity are consumed in succession without putting any time interval between the consumption of one unit and of the next. Judged from this rigid standpoint practically no commodity is found to be an exception to the Law of Diminishing Utility.

There have been Economists who have tried to find out exceptions to the Law of Diminishing Utility and much has been made of the inapplicability of the law to drinks, narcotics, good books, curios and to money. To argue that one can go on consuming the same drink or the same narcotic or reading the same book or collecting the same curio incessantly is to ignore facts. In fact all satisfaction fails if repeated and even the best book in the world will grow dull when the most appreciative reader is reading it repeatedly without any interval.

The case of money is peculiar. It is to be noted first that money is not one commodity; it is a representative of commodities in general and therefore the first unit of money and the second unit of money do not represent the same thing. The Law of Diminishing Utility as we have shown above is strictly applicable only when one and the same commodity is being repeatedly consumed. Even then however there is a special sense in which the Law of Diminishing Utility is applicable to money. As we get more and more money we try to consume less and less important commodities. With the first few units of money a man would naturally purchase

his prime necessities. As his income increases, he purchases first comforts and then luxuries. This means that the first few units of money satisfy more urgent wants than the later doses, or that a rupee out of a small income is worth more than a rupee out of a large income. This is only another version of the Law of Diminishing Utility and it is on this that we base all our plea for progressive taxation or for equal distribution of income.

Q. 4. State and explain the Law of Demand. (B A., 1934.)

The Law of Demand follows as a direct corollary from the Law of Diminishing Utility. If the consumption of a large number of doses would reduce the Marginal Utility of a commodity, it is apparent that a large number will not be purchased unless the price is sufficiently low. On the other hand, a small supply of a commodity would mean a high Marginal Utility and people would be willing to purchase only a small amount when the price is high. The Law of Demand is merely a scientific statement of this relation between price and demand. We can define the

law in the words of Alfred Marshall:

Marshall's  
statement

“The greater the amount to be sold, the smaller must be the price at which it is offered in order that it may find purchasers, or, in other words, the amount demanded increases with a fall in price, and diminishes with a rise in price.”

Q. 5. Write a note on Demand Schedule. (B A., 1926.)

By Demand Schedule we mean a table showing the amounts demanded at different prices. The price-figures are generally arranged either in an ascending or in a descend-

ing order and appropriate demand figures are put against them. A Demand Schedule may be drawn

|                |   |
|----------------|---|
| Individual and | in respect of an individual consumer or |
| market Demand  | in respect of a market. The market      |
| Schedules      | demand schedule is merely an aggregate  |

of the demand schedules of all individual consumers coming to a particular market.

The Demand Schedule being composed of two variables—one depending on the other—it can be easily translated into a graph with the two axes representing price and demand. The following example will illustrate a Demand Schedule.

| <i>Price</i> | <i>Demand for fountain pens</i> |
|--------------|---------------------------------|
| 15/          | 100                             |
| 12/          | 125                             |
| 10           | 150                             |
| 8/           | 200                             |

Q 6 The following wrong example was given by a candidate in illustration of the Law of Demand.

| <i>Price ( rupees )</i> | <i>Demand ( units )</i> |
|-------------------------|-------------------------|
| 10                      | 10                      |
| 9                       | 9                       |
| 8                       | 8                       |
| 7                       | 7                       |
| 6                       | 6                       |

Correct the above table by suitable changes in the amount of demand and give reasons for your answer (B A. 1941)

The Law of Demand as we have shown above is based on the Law of Diminishing Utility and it therefore, follows that with a fall in price consumers will find it possible to consume even those units of which the Marginal Utility is

low. The decline in the price represented in the above table should be accompanied by an increasing demand, the rate of increase depending on the elasticity of demand. A set of ascending figures should, therefore, replace the demand figures of the above table. The following may be taken as a corrected version of the table given in the question-paper.

| <i>Price (rupees)</i> | <i>Demand (units)</i> |
|-----------------------|-----------------------|
| 10                    | 10                    |
| 9                     | 12                    |
| 8                     | 15                    |
| 7                     | 20                    |
| 6                     | 25                    |

It should, however, be noted that in exceptional cases the demand for a commodity may decline even when the price is falling. This will be so, for example, when the fashion for a commodity is receding, and also, more generally, when people experience the falling phase of a trade cycle, i. e. during a downward movement of trade and industry. Besides, a fall in price may lead to a fall in demand if a substitute is becoming cheaper still or when a complementary commodity is showing a marked rise in price.

Q. 7. What do you understand by "Elasticity of Demand"? Illustrate your answer by examples. (B. A., 1938, 1936, 1925, 1921.)

Q. What is meant by Elasticity of Demand? Explain why the demand for luxuries is usually elastic, while the demand for necessities is inelastic. (B. A., 1942)

The relation between price and demand is usually one of inverse variation, provided, of course, the change in demand is caused by a change in price. A fall in price will

increase demand and a rise in price will lower it. Thus, any change in price will bring into operation the flexibility or changeableness of demand. But this flexibility will be different in different cases. A fall in price will cause a material change in the demand for soap or for chocolates but a similar and equivalent fall in price will increase very little the demand for wheat or rice or mustard oil or salt. We distinguish between these two cases by holding that demand is more elastic in the former case than in the latter.

Elasticity of Demand thus means the degree of change in demand caused by a change in price. If there is an appreciable change in demand as a result of a small change in price we say that the elasticity of demand is great, or simply that the demand is elastic. On the other hand, if a small change in price causes only a very small change in demand we say that the elasticity of demand is small

Demand elastic for luxuries and inelastic for necessities

or that the demand is inelastic. It is almost apparent that demand will be elastic for articles of luxury and comfort and inelastic for articles of necessity. In the case of the former, a fall in price will stimulate consumption considerably and a rise in price will discourage consumption to a great extent. In the case of the latter, neither a fall nor a rise in price will have much effect on increasing or reducing consumption.

Certain special cases may be examined here. If the use of a commodity constitutes a habit people would not be able to give or even to reduce consumption in case of a rise in price and hence the demand for such articles (e.g. opium, tobacco) will be often found to be inelastic.

Conventional necessities

If an article has many uses (s.g. iron, water) its demand is likely to be elastic. All its uses will not certainly be of the same importance, and so consumption will be restricted to the more important uses when price is high, and consumption will be extended to the less important uses when price is low. The present war is showing us many examples of restriction of consumption of many commodities to the more important uses.

Articles with alternative uses

If an article has substitutes the demand is likely to be elastic, for there is the likelihood of a shift of demand away from the commodity in case of a rise in price, and a shift of demand from the substitutes to the commodity concerned in case of a fall in price.

Articles having substitutes

Q. 8. Consider the effects of Elasticity of Demand on (a) taxation, and (b) monopoly profits. ( *B. A., 1936.* )

Q. Show the importance of Elasticity of Demand in theoretical and practical problems. ( *B. A., 1915.* )


Elasticity of Demand naturally affects the price of a commodity to the extent the demand is important, and hence every theoretical and practical problem concerned with price changes has to take this elasticity into consideration. There are innumerable problems of practical policy in which the final decision rests on the degree of actual or anticipated change in price, and in every one of these proper attention has to be paid to the Elasticity of Demand.

In taxation, for example, every Government has to find

out how far a particular tax will raise prices. The extent of the effect of a tax on prices is important from three standpoints—from that of the receipts of the Government out of the taxes that of the consumers surplus of satisfaction, and that of the sharing of the burden of the tax between the seller and the buyer. The last problem of incidence is one of great importance. A tax always tends to raise the price of the commodity taxed and the more the inelasticity of the demand the higher will be the rise in price and therefore the greater the share of the burden borne by the consumer. Besides a tax may by raising the price affect much the surplus satisfaction of the consumers and from this standpoint a tax outwardly sound may have to be abandoned. *Lastly if the demand for a commodity is very elastic a tax on it may reduce its consumption so much that the taxing authority will fail to raise a large revenue.*

∫ The monopolist has also to take Elasticity of Demand into consideration in determining the price at which he will sell. If the demand is elastic he will fix a low price sell a very large quantity and thereby earn a large total profit though the rate of profit per unit is small. If the demand is inelastic the monopolist will get his maximum revenue by selling a restricted output at a high price. If the demand is inelastic to one set of consumers and elastic to another the monopolist will find it profitable to practise price-discrimination charging a high price from the former set and a low price from the latter.

The terms of trade in international trade also depend on Elasticity of Demand. The limits are set by comparative costs, but between the two limits the actual terms of trade depend on the 'reciprocal intensity of demand,' i.e. on the elasticity of the demand of each country for the other country's goods.

Q. 9. How would you measure Elasticity of Demand ? 

The broad distinction between great elasticity of demand and small elasticity has to be given precision by adopting a standard for the measurement of Elasticity of Demand. Marshall devised a very simple method of measurement that has been generally accepted by Economists. According to Marshall, Elasticity of Demand should be regarded as unity when the change in demand is exactly inversely proportional to the change in price, or more simply, when, after a change in price, the product of multiplication of the price and the amount demanded remains unchanged. Elasticity of Demand is to be regarded as more than unity, i.e. demand is to be regarded as elastic, when a fall in price leads to an increase in the total amount of money offered by the buyers or when a rise in the price leads to decline in this total. —and less than unity When this total falls with a fall in price or rises with a rise in price, demand is to be taken as inelastic, i.e. Elasticity of Demand is to be taken as less than unity. The following example will show clearly how this method is actually used.



| Price | Demand | Total demand price |   |
|-------|--------|--------------------|---|
| 8/    | 10     | 80                 | } $e > 1$ : $e$ demand is elastic   |
| 7/    | 12     | 84/                |   |
| 6.    | 14     | 84/                |   |
| 5/    | 16     | 80                 | } $e = 1$ : $e$ demand is neither very much elastic nor very much inelastic |
|       |        |                    |   |
|       |        |                    | } $e < 1$ , : $e$ demand is inelastic                                       |

A rough measurement of Elasticity of Demand can be made by dividing the percentage change in demand by the percentage change in price. Elasticity of Demand can be taken to be more than equal to or less than unity according as this quotient is greater than equal to or less than unity.

✓ Q 10 Write a short note on Consumer's Surplus.  
(B A 1926)

Whenever a commodity is purchased and consumed the consumer secures a net gain of satisfaction. On the one side the consumption or even the anticipated consumption of the commodity gives him a definite quantum of satisfaction. On the other side the fact that a price has to be paid for the commodity means some amount of dissatisfaction for the amount of money that is foregone. The difference between satisfaction gained and satisfaction lost represents the foregoing of the consumption of a number of other commodities that could have been purchased by this amount of money. The difference between the satisfaction obtained from the consumption of a commodity and the dissatisfaction arising from the payment of price is called Consumer's Surplus.

This Consumer's Surplus is measured by the difference between the maximum that a consumer would pay for the

commodity rather than go without it and the price that is actually paid. The former is a measure of the Total Utility obtained and the latter is naturally dependent on the Marginal Utility and the number of units consumed.

Consumer's Surplus arises because the supply conditions of most commodities are such that consumers have not got to pay the maximum price they would be willing to pay rather than go without the commodity. We get most of our requirements at prices cheaper than what they are worth to us. If we get for a pice a match box for which we could have paid two annas if match boxes had been scarce, we are getting a Consumer's Surplus the economic measure of which is 7 pice.

✓ Q. 11. Show how Consumer's Surplus is related to individual demand price and market price, and how it varies with the variation of either. (B. A., 1941.)

Consumer's Surplus is the surplus of satisfaction that arises because the consumer has not got to pay actually as high a price as he would be willing to pay rather than go without the commodity wanted. That is to say, the

|  |   |
|--|---|
| Market price is generally lower than individual demand price | market price of a commodity is generally lower than the price that an individual would find himself willing to pay. The individual demand price depends on the individual's estimate of the Utility |
|--|---|

obtainable from the consumption of the commodity, while the market price depends on the Marginal Utility of the commodity to all the *effective* buyers in the market and also on the conditions governing the supply and cost of Production. The individual demand price is usually higher

than the market price, in some cases, and particularly with regard to the marginal purchase, the individual demand price is equal to the market price. In the former case, there is a positive Consumer's Surplus, in the latter case, the Consumer's Surplus is nil. The individual demand price may also be lower than the Marginal Utility but as no purchase would be made in that case the question of Consumer's Surplus does not arise.

If the Consumer's Surplus depends on the individual demand price and the market price, it will naturally vary with variations in either. The individual demand price may increase if the commodity comes to be more fashionable, or if new uses are found for the commodity. If the price ruling does not increase to the same extent as the individual demand price, the difference between the two will be greater and hence Consumer's Surplus will increase. Similarly, a fall in the individual demand price resulting from some unwillingness to consume the commodity will reduce the Consumer's Surplus. On the other hand, it is easy to realise that any rise in the market price will reduce the Consumer's Surplus and that any fall in it will increase this surplus.

An increase in the individual demand price or a fall in the market price will increase Consumer's Surplus, while a decrease in the individual demand price or a rise in the market price will reduce this surplus. In short, anything that increases the difference between the individual demand price and the market price increases Consumer's Surplus and anything that reduces the margin of difference makes the surplus smaller.

Q. 12. Show that a consumer closes his purchase of a commodity as his Consumer's Surplus reaches the maximum. ( *B. A., 1945.* )

The demand price of a consumer for a particular commodity goes on diminishing until the demand price for the marginal unit is just equal to the price. So long as the demand price for a unit is greater than the market price, the consumer goes on buying more of the commodity, and every such purchase makes a net addition to the Consumer's Surplus attained by him. But as he buys more, his own demand price declines and there comes a stage when the price that he is just willing to pay for one more unit is equal to the market price. Up till this point, the Consumer's Surplus goes on increasing and the total surplus reaches its maximum when the Marginal Utility and the price are equal. After this stage, the demand price for an additional unit will be lower than the price and, consequently, any further purchase will bring negative Consumer's Surplus and thus reduce the total Consumer's Surplus. A consumer, therefore, will close his purchase when his own marginal demand price for a commodity has become equal to the price ruling in the market, i.e. at the stage at which his marginal Consumer's Surplus is nil and his total Consumer's Surplus is at its maximum. He will be induced to buy more only if the price falls or if something happens to intensify the demand for the commodity at the existing price.

✓ Q. 13. Explain clearly the Law of Substitution or Equi-marginal Utility. <sup>✓</sup>

The Law of Equi-marginal Utility is in a sense the major

premise of all economic analyses. In every problem of Production or Consumption there is the necessity of a choice between alternatives particularly because the resources by which the alternatives are to be commanded are limited. A consumer with a ten rupee note in his pocket has to decide what will be the best manner of distributing the amount of money available among the alternative possibilities of purchase. A primitive housewife had to decide on the best way of distributing her stock of wool between the making of vests and of socks. And a modern producer has to decide what would be the best proportion for combining Land Labour and Capital.

The principle everywhere is the same because the objective everywhere is the same. The consumer wants so to distribute his consumption as to be able to get the maximum amount of satisfaction from his resources. the producer allocates his resources in such a manner that he gets the maximum output. If he finds by experience that one particular allocation gives him a larger aggregate return than another he naturally chooses the former. In the case of Consumption if a consumer has to choose between two commodities he will find that the best distribution—the one that would lead to maximum satisfaction—would be that under which the Marginal Utilities of the two commodities are equal. So long as the Marginal Utilities are not equalised there will be gain if one dose of the article with the higher Marginal Utility is substituted for one dose of the article with lower Marginal Utility i.e. by having one dose more of the former and one dose less of the latter. This

very process of substitution leads again to a lowering of the Marginal Utility in the former case and a raising of the Marginal Utility in the latter, and in this way gain tends to increase so long as equality of Marginal Utilities is not obtained. The same principle operates in Production where we can call the tendency by the name of the Law of Equi-marginal Returns.

This Law of Substitution or of Equi-marginal Returns or The Law of Substitution is fundamental in Economics of the maximum aggregate satisfaction is fundamental in Economics. It is this law that lies behind Consumption, behind the decision between expenditure on current consumption and postponement of present satisfaction, (i) in consumption, behind allocation of resources and behind the present day concept of opportunity cost. In Consumption the equalising of Marginal Utilities is (ii) in production brought about because of the operation of the Law of Diminishing Utility and in production because of the operation of the Law of Diminishing Returns.

Q. 14. Is the consumption of luxuries beneficial to society from the economic point of view? (*B. A., 1926.*)

The question whether the consumption of luxuries is beneficial to society is more a question of welfare-Economics than of economic theory. From the standpoint of pure economic theory the benefit or otherwise of the consumption of a commodity is immaterial. Any consumption is significant provided it satisfies a want that is really felt and any production is justified provided it would make such consumption possible.

But from the standpoint of economic welfare we can

always distinguish between Consumption increasing the social well-being and Consumption decreasing it. There are certain commodities the consumption of which is definitely undesirable. Social welfare would increase if such commodities are prevented from being produced and if the Labour and Capital devoted to the Production of these are diverted to some other more desirable use. It is, however, to be noted that all luxuries are not undesirable. There are some which raise up the standard of life and hence exercise indirect effect on efficiency and numbers. Besides, these give rise to a field of employment for artistic skill. But on the other side much Labour and Capital may be made available for producing things of prime necessity by prohibiting the production of commodities that yield definitely undesirable results. The case for prohibition is a case in point. We may conclude, therefore, that a wide latitude has certainly to be given to the consumers in respect of their consumption of luxuries.

The freedom of choice of the consumers ought to be maintained so long as this freedom does not decrease or prevent the increase of social welfare. Moreover, there are some articles which may be regarded as unnecessary luxury by some and as fundamental necessity by others. A fountain pen or a wrist watch or a telephone may be mentioned as examples. Society however, is perfectly justified in prohibiting the production of commodities that create injurious effects.

## CHAPTER IV

### Production

Q. 1. What are the factors of Production? Discuss their relative importance

By factors of Production we mean those essential requisites without which no Production can be carried on. Naturally there would appear to be two fundamental factors of Production, namely *nature* and *man*. Behind every Production will be found the co-operation between man and nature, the attempt by man to utilise the beneficent forces of nature, to overcome the obstacles set by nature, and, if possible, to convert the malevolent forces of nature into benevolent ones.

It is usual, however, to analyse the requisites of Production further. The prime factors of Production are taken to be Land, Labour and Capital. By Land we mean any free gift of nature—everything given to society by nature in earth or water, in air, light or heat. By Labour we mean human exertion of the body or of the mind undertaken with a view to securing some material reward. It is necessary to note that Land and Labour are the two primary factors of Production. In early society, Production meant the application of human labour upon natural resources.



Gradually however Capital came to be used By Capital we mean the man made appliances like machines ploughs etc that are used to facilitate the application of Labour in Production Production with Capital means the application on natural resources of human labour aided by man made appliances and this capital using Production has been universal since man learnt to devise tools and implements

With the increase in the complexity of Production the necessity for a proper co ordination of the factors has come to be felt Efficiency of Production always depends on an appropriate combination of the factors of Production and this function of co-ordinating the factors is known as the function of Organisation and is performed by a class of men of high efficiency—known as Organisers or *Entrepreneurs*

Lastly we have to note that no Production can be undertaken unless there are some men to undertake the uncertainties and risks associated with the running of any business The function of bearing risks and uncertainties is also an important one which must be undertaken by some responsible persons Risks can to some extent be anticipated and provision can be made for eliminating them but there are unforeseeable uncertainties the bearing of which requires some boldness on the part of the producer This bearing of risk and uncertainty can thus be taken as another factor of Production

**Q 2** State and explain the Law of Diminishing Returns as applied to agriculture (B A 1937, 1926)

The Law of Diminishing Returns has been enunciated

by Alfred Marshall as follows : "An increase in the capital and labour applied in the cultivation of land causes in general a less than proportionate increase in the amount of produce raised." The law has been empirically established from the observation of doses of Capital and Labour. It has been the usual experience of cultivators in every country that the additional return from additional doses of Capital and Labour would go on decreasing as more and more doses are employed, or that the total return would go on increasing at a diminishing rate. It is possible that the first few doses of Capital and Labour applied to a plot of land uncultivated hitherto would result for some time in increasing returns, and it is also likely that the operation of diminishing returns may be held in check by increasing artificially the fertility of the soil, or by using better technique of agriculture or by the use of better implements and seeds. But, as a general tendency, it still remains true that the marginal return from the intensive cultivation of a given plot of land would gradually decrease and that, consequently, the cost per unit of the output would gradually increase.

✓ Q. 3. State the Law of Diminishing Returns with its limitations ( *B. Com., 1940 ; B. A., 1926.* )

Q. "Labour and capital cannot be withdrawn from a part of the land and concentrated on the rest without causing a reduction of social income." Bring out the significance of the statement. ( *B. A., 1944.* )

The Law of Diminishing Returns is a general tendency

discernible in all branches of Production where nature plays a dominant part. In agriculture the operation of the law is particularly visible, in branches of Production like mining, forestry and fishing a tendency towards diminishing returns or increasing cost is often manifest. The operation of the law is least experienced in manufactures because here man tries so far as possible to overcome the limitation of nature and thus to secure more than proportional returns.

But even in agriculture there are exceptional cases in which the Law of Diminishing Returns may not operate. *First* if there is an improvement in the arts and implements of agriculture it may be possible to check the operation of the law. *Secondly* if there is an improvement of the fertility of soil either as the result of the application of manures or as the result of fitful course of development of soils often experienced the land may yield increasing returns. And *lastly* it is possible that the first few doses of Labour and Capital applied to the cultivation were inadequate for the development of the full powers of the soil, in such a case the application of increasing doses of Capital and Labour would mean more than proportionate increase in return. These conditions are particularly to be found in new countries where the Law of Diminishing Returns is often found to be inoperative. In old countries too the operation of the law is often held in check as we have seen by scientific inventions and by improvements in the technique of agriculture.

It is however to be remembered that the conditions of

exceptions to the Law of Diminishing Returns come only infrequently. We cannot expect a new invention every day, nor can we expect that there would be an improvement in the fertility of the soil every season. As a general tendency the Law of Diminishing Returns remains true practically in every case.

Q. 4. Show how far the Law of Diminishing Returns is applicable to the manufacturing industries.

Our usual experience is that the Law of Diminishing Returns does not apply to manufacturing industries. In manufactures, the dominant part is played by man—by man-made machines and by technique devised by man—and the objective of every one of these is to neutralise and, if possible, to overcome the limitations and obstacles set by nature. So long as men are successful in their attempts to overcome nature, the law of increasing returns will operate. But a limit is sure to come soon—either on account of the scarcity of raw materials or on account of the fact that managerial ability cannot grow *ad infinitum*.

Besides, there is another reason leading to the operation of the Law of Diminishing Returns in manufactures. If any one factor of Production is applied in a disproportionately large quantity while other factors are applied in comparatively small quantities, resources will not be able to yield their maximum. Hence, if there is any inappropriateness in the combination of the factors of Production even in manufactures, the Law of Diminishing Returns will be found to operate.

Q 5 The Law of Diminishing Returns is only one phase of the universal law of variable proportions" Elucidate fully (B Com 1932)

The simplest way to explain the operation of the Law of Diminishing Returns is to direct attention to the limited fertility or productive power of natural resources. It can be pointed out that on account of this limitation of fertility the later doses of Capital and Labour would find a poor response from the land cultivated and this can be put forward as an explanation of the operation of the law. This 'riggardlessness of nature can also be put forward as an explanation of the operation of the Law of Diminishing Returns in mining fisheries etc

It is however possible to discover a more fundamental reason for the operation of the law—a reason which shows why the law applies not only in agriculture but under certain conditions in manufactures too. In every Production it is essential that the factors of Production should be combined together in an appropriate proportion. If that proportion is disturbed i.e. if one factor is applied in a relatively large quantity while the others are applied in relatively small quantities the returns will cease to grow proportionately. The proportion between the factors can be easily varied and when this variation leads to a maladjustment in the factor combination, diminishing returns would result. A variation away from the most appropriate combination would diminish the marginal returns, while a variation towards this most appropriate combination would increase the marginal return. In agriculture therefore the

Optimum combination of factors of Production

law of diminishing returns operates because maladjustment in the combination of factors is caused by increasing the amount of labour and capital employed while keeping the amount of land constant. In manufactures the law applies when the supply either of raw materials or of managerial ability cannot be increased *pari passu* with the increases in the other factors of production.

The law of D. R. arises from inappropriate factor combination

Q. 6. Explain clearly the theory of population as developed by Malthus.

Before the time of Malthus it was usual for economists and politicians to regard a large population as a blessing for the nation as a whole and as late as in 1796 William Pitt expressed his gratitude to the man who enriched the nation by having many children. In 1798, however, the publication of Malthus's essay released a cold wave across this optimism, and for nearly a century the pessimistic forebodings of Malthus continued to damp the enthusiasm of those in favour of a large population.

Malthus based his study mainly on observed facts gleaned from travel accounts and history. His first conclusion was that population had a general tendency to grow at a rate faster than food supply. The general tendency for population was, according to him, to increase twofold every 25 or 30 years. Food supply, however, would not increase so fast, as a larger population would mean the cultivation of the unfertile land not capable of yielding much. As a general rule population would increase in the proportion represented by the G. P. series 1, 2, 4, 8, 16...

Malthus's premises

while food supply would increase in the A P series  
1, 2 3 4 5

Malthus concluded finally that on account of the disparity between the rate of growth of population and that of food supply a time would soon come when the available amount of food supply would become inadequate for feeding the entire population. The natural result of this would be to cause starvation disease malnutrition growth of social practices like infanticide and as a last resort war.

Conclusion

Positive checks These are called by Malthus the *positive checks* on population—checks that would inevitably come into operation whenever the population has crossed the limits set by the available amount of food supply.

In a sense therefore the population problem would solve itself automatically for whenever population would grow too large food supply would be inadequate positive checks would come into operation and thus population would come down to a lower level. Overpopulation can therefore be expected to correct itself automatically through the inevitable positive checks.

But these positive checks are wasteful in their operation and undesirable in their incidence. No civilised society would want that a relief measure for their social problems should consist of war and disease or of starvation and infanticide. Malthus, therefore wanted people to adopt *preventive checks* in order that the problem of overpopulation and the necessity for positive checks might never arise at all. By preventive checks he meant late marriage and celibacy.

Preventive checks

wherever possible, and also voluntary restraint during married life. If all members of society would be alive to their responsibilities and would desist from marrying and particularly from bringing children into the world until they have an adequate income, overpopulation would never come. Malthus's teaching can, therefore, be summed up very briefly by stating that population has a tendency to increase faster than food supply and that it is the duty of a civilised society to keep this tendency in check.

Q. 7. How far is the teaching of Malthus relevant to the population problem of our days ? (*B. Com., 1934.*)

Q. Discuss fully the short-comings of the population-theory of Malthus.

Malthus foresaw in 1798 a dark misery for all peoples. His dark forebodings have not, however, proved real. About a century and a half have elapsed since Malthus wrote, but even now we do not find any tendency for population to grow inordinately large. The misery and scarcity that Malthus had anticipated have not materialised. There are certainly some short-comings in the theory of Malthus and it is these short-comings that have made the Malthusian forecast unrealised.

The short-comings of the theory of Malthus lie partly in the objective changes that have taken place round about us during the last century and a half and partly in defects in the theoretical apparatus that Malthus had developed. From the standpoint of facts, we find first that Malthus was not in a position to foresee the immense development of industry, trade and

Malthus could not foresee the industrial development of the 19th Century



market that took place in the 19th century, enabling small manufacturing and trading countries to support large populations through international trade. The whole world grew into one single economic unit and this stayed off the danger of scarcity of food materials. *Secondly,*

Malthus erred in his conclusion about the relation between increase in income and increase in numbers. According to him an increase in income would make the earner less cautious and therefore he would marry early and beget children inconsiderately. In the present day world we find that it is the very opposite of this that is true. A rise in income brings a desire to live at a high standard of life and this puts such a pressure upon one's income that the individual has to exercise great caution in respect of marrying and getting children. An increased income in the present day society means a low birth rate and not a high one.

*Thirdly,* the biologists of to-day contend that the reproductive instinct is not really so strong as Malthus took it to be. The popularity of contraceptive devices that separate reproduction from sexual gratification is a pointer in this direction. Reproductive instinct not really so strong as Malthus assumed. Besides it is also contended by biologists that the power of reproduction itself diminishes with the increasing complexity of modern civilisation. Raymond Pearl has pointed out that the power of reproduction after increasing rapidly for some time slowly decreases and ultimately the rate of increase comes to be nearly constant at a very low level.

From the standpoint of analysis Malthus's theory suffers

from the defect of inadequacy. He studies the law of the growth of population and also the law of the growth of food supply, and emphasizes the disparity between the two rates of growth. It does not occur to him that the growth of one may have an effect on the growth of the other—that an increase of population may mean so large an increase in productive efficiency that the supply of resources would be more than proportionately increased.

More important than this is the fact that Malthus lays too much emphasis on means of subsistence, holding that overpopulation begins when the subsistence limit is crossed. The really scientific comparison should be one between population and welfare or more simply between population and wealth. The mere fact that people are being just sufficiently fed is not a test of the desirability of a particular population. The test of desirability would be the level of welfare, or the amount of wealth, or the average income of the members of the community.

✓ Q. 8. Explain clearly the theory of optimum population.

Q. Is an increasing population always beneficial to a country? ( *B. A., 1932.* )

Malthus took food supply as the only standard for measuring the desirability of a particular population. Adequacy of food supply would mean that population has not become undesirably large while scarcity would mean that overpopulation has arrived.

Modern economists however, point out that the real antithesis is not one between population and food supply but between population and wealth. Man wants something beyond being properly fed, he wants a

The real anti-thesis is between Population and Wealth

of population is, therefore the average prosperity of the people. A very small number may mean a low scale of productivity and a very large number may be unnecessary. If we can find out the number of population

that would make the average return to the people highest under a given set of conditions that number can be taken as the most desirable or the *optimum* number.

For every country there is an optimum population which results in the highest amount of wealth per head under a given set of circumstances. If the population is very small the other resources of the country would remain undeveloped and incompletely utilised. If the population is too large the other resources may prove inadequate, thus affecting the productivity of the factors. In between these extremes there is in every country under given conditions a particular number that together with the other resources available in

the country would make the factor combination the most appropriate one and would hence maximise the average income of the people. This number is the *optimum* and *overpopulation* and *underpopulation* lie respectively above and below this level.

An increase in population is therefore beneficial only when

the country is *underpopulated*, i.e. when the population is too small for securing a full development of the other resources of the country. In an overpopulated country, i.e. in a country in which the point of maximum return has been already crossed, an increase of population would only increase the maladjustment further, causing incomes to fall to a greater extent. It is, however, to be noted that an increasing population is often desired on extra-economic grounds. In Totalitarian States, for example, we find a recrudescence of the old view that a large population is an important element of strength for a country that adopts or wants to adopt an aggressive policy, and in these days *machtpolitik* it is natural that the political benefit of a large population would be allowed to outweigh all considerations from the economic standpoint.

✓ Q. 9. The problem of population is not one of mere size, but of efficient production and equitable distribution. Explain.

Malthus regarded any tendency for the size of population to increase as a tendency towards danger. Today, however, we know that the increasing size of a population does not matter if productive efficiency is increasing at a more rapid rate. If production is efficient, a large population can easily be maintained.

But at the same time it is essential that the total dividend of the country should be properly distributed among the people. Generally we study income with reference to the average but an average may conceal a very unequal system of distribution. In a country in which 100 men earn Rs. 500 each, the average income is Rs. 500 ; in another country in which 10 men earn Rs. 3200 each and 90 men earn Rs.200 each, the average income is also Rs.500. But

it is clear that from the point of view of social welfare the former represents a better situation than the latter

The aim of every country wanting to maximise its social well being would, therefore, be threefold—(1) to increase the size of population only so long as it increases efficiency of production, (2) to make production as efficient as possible, and (3) to make the distribution as equitable as possible

Q 10 Discuss the various elements that affect the efficiency of workmen (B A, 1939)

The efficiency of labourers depends upon a number of factors. Among these we may mention first those affecting the physical strength of the labourers. In spite of the rapid improvements in technique that are daily taking place, labour still requires physical strength and a group of persons who are physically strong can expect to be of a high degree of efficiency. This physical vigour depends

|  |   |
|--|---|
| Racial factors,<br>Climate and<br>Environments | on racial factors on climate on the availability of nutritious food and good clothing and shelter and lastly, on the contentment that prosperity can bring. In some cases the nature of the |
|--|---|

|                         |  |
|-------------------------|--|
| Nature of<br>occupation | occupation itself affects efficiency, there are some occupations which are essentially sedentary and impair efficiency and there are others which are so pleasant as to be able to increase the zeal for work. |
|-------------------------|--|

|                                 |   |
|---------------------------------|---|
| General and technical education | Besides physical strength, the other factors that are essential are first a fairly high level of general education for the purpose of cultivating the intelligence, and secondly, a specialised technical education. Modern production is complex and |
|---------------------------------|---|

an individual labourer is bound to specialise himself in a particular line or two. For this, technical education is a great necessity. Technical training was formerly acquired through the system of apprenticeship; at the present day this training is generally imparted by special institutions.

To a large extent efficiency of labour depends on the conditions and environments under which labour is carried on. Good pay, good prospects, holidays, rest-intervals, short hours of work, good dwelling and recreation facilities, all these increase the efficiency of labour and in respect of these the employers have a very important duty to perform.

Some psychological influence may be made effective by a mere change in the attitude of people towards manual labour.

In general manual labour is held as undignified and if manual labourers do not exert themselves much, the reason may lie in some sort of an inferiority complex. If manual labour comes to be regarded as at least as dignified as intellectual labour, contentment will replace discontent and hence efficiency will increase.

/ Q. 11. Describe the functions of Capital in modern industry and commerce ( *B. Com. 1929, 1930.* )

Q. Define Capital and discuss its main functions. ( *B. A. 1942, 1937.* )

For carrying on production, it is essential to apply the fundamental factors of production, namely, land and labour. We can conceive of a primitive system where land and labour were the only factors of production used. But very early in our society's history people could realise that production

would be facilitated if human labour were aided by artificial equipments. Capital is the name we give to all these aids to human labour and we may define capital, after Adam Smith, as that part of a person's stock from which he expects to derive an income.

The main function of capital follows from the definition—it is to help labour in production, to make labour more productive than it would have been without capital. A cultivator with his ploughs can produce more than he can without his ploughs, a jute mill with its machines can produce much more than it could without machines. The process of production with capital is roundabout and complicated but on the whole speed of production is increased and the output considerably multiplied.

We may moreover take note of the fact that modern production requires a command over a large volume of resources—for the purchase of materials and machines, for the carrying of stocks and for running advertisement campaigns. In the present day world the competitor with the largest purse wins and command over capital therefore, means command over success.

Q 12 'Capital is a class of goods, not a fund of value'  
Explain ( B Com, 1932 )

In ordinary language the word capital is often used to denote the total value of the resources employed in business, or more simply the total amount of money sunk. The real meaning of the term capital is the class of goods that aid labour in production. In ordinary language capital

is stated as a fund of value ; but, the economist in making a list of a businessman's capital would take into consideration the tools, implements, machines, materials, factories, etc., with the help of which production is carried on. Some economists distinguish between capital goods and capital in the sense of a money-fund, but this distinction is unnecessary. \

\Q. 13. Is money capital ? Justify your answer by appropriate reasoning. ( B. A. 1942. )

Any means of production that has been produced by human effort can be regarded as capital. Ordinarily capital is taken as the equivalent of the money value of the means of production, but strictly speaking, the name has to be confined to describing the actual physical instrument of production. Money in this sense can be capital only when it is actually being used to secure an income, or, according to some, when it is held with the intention of being put to productive use. To an individual, money deposited in a bank or lent to another, is capital because an income in the shape of interest is coming in. To a business man a fund of money is his floating capital, not yet used in any particular direction, but capable of being immediately put to some productive use. To society as a whole money is nothing if it does not represent something 'real', some definite item of wealth. *Society's capital, therefore, consists not of the money-funds it possesses but of the physical means of production which are themselves the result of human labour.* We can, for the sake of convenience, sum them up in terms of their money values, but a measure of a thing is not the thing itself.



Q 14 Discuss the functions of capital in modern industry and commerce ( *B Com 1929, 1930* )

Capital has three main functions in the present day economic structure. *First* capital provides tools and instruments factories and machines making human labour much more productive than it otherwise could have been. *Secondly* capital enables the producer to get command over 'stocks of goods articles ready for consumption in warehouses and shops and materials awaiting manufacture and thus it enables us to adopt roundabout and very productive methods of production. And *thirdly* capital enables us to take risks—to produce in anticipation of demand instead of waiting for orders to experiment with new processes new materials new markets whenever we think there is a chance of our gaining by taking the risk '.

The services of capital are more obvious in the case of the individual businessman. He must have his factory, his machines his powerplant. He must have always a large stock of raw and unfinished materials in his hand representing locked up capital. He requires capital for meeting unforeseen fluctuations and emergencies. He must have a supply of working capital to bridge the time-lag between the incurring of expenditure and the realisation of sale-receipts. And besides he must always carry some stock in anticipation of demand and this also requires locking up of capital.

/ Q 15 Point out the different factors that affect the supply of capital in a country ( *B A, 1945* )

Q. Discuss the conditions on which the supply of capital in a country depends. (B. A., 1936.)

The supply of capital means in the final analysis the volume of saving in the country and any factor that stimulates saving is a factor increasing the supply of capital. Saving can increase only when there is a growing desire for saving accompanied by increased facilities for saving *i.e.*, saving depends on the subjective conditions governing the will to save as well as on the objective conditions governing the power to save.

Among the factors affecting the desire to save some are very easily discernible. If a man has a strong affection for the members of his family or if he has foresight and wants to provide for unforeseen future emergencies, he will naturally try to save as much as possible. Some people are actuated to save by the desire to earn an income through investment, some by the desire to enjoy the prestige that the possession of money gives and some perhaps only to satisfy their gold-lust and to see a huge amount accumulating before their eyes.

The mere possession of a desire to save, however, is not enough. The objective conditions governing the power to save must also be taken into consideration. The most important among these is that the potential saver must have a surplus over his elemental needs in order that he may be able to save. The existence of a money economy, as

distinguished from a barter economy is another essential condition. And then if there are good banks and insurance companies to make saving safe as well as profitable its volume will increase. Lastly we may note that unless there is security and good government in the country no saving will be made. Security of property is one of the primary conditions of saving.

The relation between the rate of interest and saving is peculiar. Generally an increase in the rate of interest may be expected to increase saving but as Keynes has shown a rise in the rate of interest by causing investments of all may make incomes lower all round and thus reduce the power to save. It is also to be noted that there may be some persons who want to provide for themselves or for their dependants a fixed annual income out of the capital saved. These men will naturally save more when the interest rate is low and save less when the rate is high.

Q 16 Write a short note on fixed and Circulating capital (B A 1928)

The distinction between fixed and circulating capital was clearly shown by John Stuart Mill who showed that some capital goods like machines or factory buildings would exist in a durable shape and would give continuous service to the producer. Some capital goods like raw materials coal could however be used only once in production, these in Mill's words fulfil the whole of their office in the production in which they are engaged by a single use. It should, however be remembered that there is no capital good that is absolutely fixed. Every capital good exhausts itself some

time or other and we can, therefore, hold that the distinction between fixed and circulating capital is one of degree only—circulating capital meaning capital goods exhausted in one use and fixed capital standing for goods that can be used for a fairly long time in the same process of production.

Q. 17. Distinguish between the different senses in which the word *capital* is used in popular and economic language. ( *B. A., 1944.* )

In popular language the word capital is used to mean a fund of money. It is often used to denote the total wealth which a man possesses and sometimes to denote the amount of money which brings him an income in the shape of interest.

In economics, capital is fundamentally a class of goods, and not a quantity of money. Here also it is possible to distinguish between *Capital goods*, or those things which are used to produce other things and *money capital* or the money value of the capital goods. The main problem is that of deciding what to include and what to exclude in the definition of capital. Some economists like Jevons regarded income and utility as identical in nature and hence considered every item of wealth to be capital because of its capacity of yielding satisfaction. Others gave a psychological interpretation and held that anything that its owner *intended* to use for earning an income should be regarded as capital.

The most common view among economists has been that the name capital should be given to those parts of wealth which are used for further production. This definition covers all we require, but it also covers land and other gifts of nature. These gifts of nature present some peculiar

characteristics and it is therefore desirable to confine the use of the name capital to those means of production which are the result of human effort i.e. to the *produced means of production*

It is necessary to look at another aspect of capital. From the standpoint of ends capital is the name given to the produced means of production. From the standpoint of origin capital means that part of the product of labour and nature which has not been used up in immediate consumption and is therefore available for future use. Capital from this standpoint represents saved up labour and saved up natural resources.

✓ Q 18 The greatest improvement in the productive power of labour and the greater part of the skill dexterity and judgment with which it is anywhere directed or applied seem to have been the effect of division of labour. Explain (B Com 1929)

Q Explain clearly the economic benefits arising from division of labour

Division of labour is one of the most important central facts of modern industrial organisation. From the point of view of the individual labourer division of labour means specialisation of each labourer in a particular task. From the stand point of society as a whole it means co operation or integration of labour. On the one side this division of labour brings *subdivision of tasks* making each operation easier than it would have been in combination with other operations. And on the other side it brings *repetition of tasks* for each labourer enabling him to

Division of  
labour is co-  
operation  
of labour

perform his work with greater ease and efficiency. "An operation", shows Clay, "if repeated often enough, becomes a habit; our bodies and brains adjust themselves to performing perfectly and without effort what at first is done only badly and with great effort".

Even the simplest form of division of labour brings first an adaptation of the task of an individual to his ability and secondly, an increase in the efficiency of the labourer on account of constant practice in one work. On the one side, division of labour *utilises* efficiency wherever it is available, and on the other side it *creates* efficiency where it had not been existent. Besides, division of labour shortens the period of apprenticeship, provides continuity in operation and eliminates the waste of time involved in passing from one operation to another. Continuous engagement in one occupation leads to a development of the inventing faculty and capital is utilised fully.

The greatest advantage of division of labour in our times has perhaps been that it has led to the application of machinery in production. Minute division of labour means that each process is reduced to a continuous repetition of an identical movement and whenever this state has been reached it becomes possible to put a machine in place of human labour. The application of machinery in production has been surely the greatest help in the way of the development of manufacturing industries in our times.

Q 18 "Division of labour is limited by the extent of the market' Discuss ( *B. A. 1945* )

The main advantage of division of labour is that it makes possible a large increase in output, through the employment of suitable groups of labourers for particular types of work and the use of highly specialised machinery. But the production of a large output is profitable only when a large and wide market is available for the disposal of the products at remunerative prices. Division of labour on an intensive scale and the consequent application of machinery would therefore be possible and worth while only in the case of those commodities for which there is a universal demand. In the case of commodities for which the demand is restricted and the market narrow the output has to be kept small and the scope of division of labour is limited. Employment of a large number of labourers, minute division of labour and production of a large output will be profitable generally in the case of commodities used all over the world or at least over an extensive area and commodities for which the demand is highly elastic. Development of communications and other factors tending to widen the extent of markets also tend to widen the scope of division of labour. The degree of division of labour, the number of labourers to be employed, the output that will be profitable to produce, all these are intimately connected with the extent of the market that can be served.

Q 19 Consider fully the economic effects of the application of machinery in production.

The application of machinery in production brings

degrading and demoralising effect of machines on labourers and to the evils of the factory system, while trade unionists oppose the extension of labour-saving devices on the ground that these will cause unemployment among the labourers

Effect on  
labourers

On the whole however, machines have caused immense advantage in the field of production and the present day civilisation is entirely based on the everwidening sphere of the application of machinery. If machines cause disadvantages and if they have their shortcomings they also bring great economies and greater possibilities. If machines sometimes cause unemployment, they create at the same time new avenues of employment. We may note in conclusion that the defects of machine production are remediable, but the advantages can never be forgone.

**Q 20** Examine the effects of machinery on labour, and discuss whether the progress of mechanical invention is injurious to the labouring classes (B A, 1925)

The effects of the application of machinery seem apparently to be beneficial from the standpoint of the labourers. These machines increase the efficiency of the labourers by making them more keen and alert, by increasing their technical skill and by raising their output generally. They relieve the strain on human muscles and take over all difficult and risky work as well as all monotonous and dull tasks. The labourers find it easy to move from one trade to another because intensive mechanisation often weakens the barrier between different trades.

It is however often argued that machines, besides



production with the help of machines cheapens the prices of all machine-made goods, consumers will have larger surpluses in their hands with which they can purchase new commodities. New industries will therefore develop and additional employment will be caused. The labourers themselves again will give employment to other labourers, *either because of their purchase of more commodities or because they may choose shorter hours of work.* And lastly, we may note that if machines applied in industry increase production, income and prosperity, savings and investment will increase and thus the total volume of employment will increase.

The history of the industrial development of England since the 19th century has been one of parallel development of machine production and of employment. It is a superficial view of things to hold machinery responsible for unemployment. The causes of unemployment lie deep down in our industrial, monetary and credit structure.

✓Q 21 Discuss the influence of inventions and improvements in machinery on (a) the wages of labour and (b) economic progress generally. ( *B Com* , 1944 )

If the contention that machines cause unemployment had been true, it would have been correct to hold that the aggregate wages, if not the wage-rates would decline with every new invention or improvement. But we know that machines in themselves do not cause unemployment in the long run, they rather increase the scope of profitable employment of labour. Recent monetary theory has emphasised the direct relation between the making of capital good

and the reduction of unemployment. This means that machine-making in the short run and machine-using in the *long run* increase the demand for labour and hence wages are also increased.

Besides, machines cause a greater demand on the skill and dexterity of the labourers. If the use of machinery increases the efficiency of labour, wages would naturally increase. In so far as machines used in different industries are similar in character, labourers are enabled to move from one industry to another and thus take advantage of the highest terms that are available.

The effects of machinery on economic progress are evident. Economic progress is primarily dependent on a large output of goods, and machines, by making it possible to produce a large volume of uniform, accurate and standardised articles at a rapid speed contribute materially to economic progress. Of course, the machine-age has brought monotony, squalor, poverty, unemployment and other evils; but these are essentially connected not with machines as such but with the manner in which their application is organised.

Q. 22. Examine the causes that lead to the expansion of business units. (B. A., 1936.)

A number of causes have combined together to bring about an expansion in the size of the business units. With the development of the possibilities of mechanised production, people are realising that the output can be enlarged and cheapened if production is undertaken on a large scale. One of the most important causes of the expansion of the

size of business units in recent times has thus been the realisation that for most commodities the larger the scale, the more efficient will be the process of production. *The economies of large scale production* arise from the application of scientific division of labour, from the use of machines and from the economy in materials and waste-products. Every producer wants to secure these economies and naturally he will feel induced to expand the scale of his operations.

Moreover, the present day economic structure has been accompanied by a large *growth of capital*. The Industrial Revolution of the 18th century would have been without significance if England had not experienced an increasing inflow of capital from the East India trade. In the same way the ever increasing volume of capital to day seeking new fields of employment is exerting a constant pressure to expand the scale of business.

To a large extent the expansion of business units has been brought about by the *widening of markets*. Division of labour and scale of production are naturally limited by the extent of the market and the development of the means of transportation in recent years has made possible a wide extension of all markets. Business units can now-a-days expand themselves with assurance because practically the whole world is their market.

The *intensity of competition* has also helped to make business units grow in size. Every unit wants to get some

advantages in addition to those enjoyed by the rivals and hence every one of these tries to expand. In the present day field of competition, large amounts of money are required for advertisement campaigns, for rate-cutting and for other competitive devices and it is natural that the competitor with the longest purse should win. All this goes to make large scale production more profitable than small scale production and to increase the size of the average business unit.

✓Q. 23. Describe the advantages of large scale production. ( *B. Com.*, 1930, 1928, 1925. )

Q. Indicate the advantages of large scale production. ( *B. A.*, 1931. )

The advantages of large scale production have been classified by Marshall into three broad categories—namely, Economy of Skill, Economy of Machinery and Economy of Materials.

From the standpoint of economising skill, large scale production is a great help. As a large number of labourers are employed, it is possible to apply division of labour both intensively and extensively leading on the one side to the maximum utilisation of skill, and on the other, to an increase in the efficiency of the labourers. Technical skill can easily be put into use and expert technicians appointed for supervision and management. The head of the firm need not concern himself with the matters of ordinary routine and he can leave himself free to deal with the questions of broad policy.

Machines can certainly be more widely used in a large-

scale factory than in a small scale one. Machines today are costly, and they cannot be put into use unless the employer has a large command over capital, an expert staff and a large market to feed. It is only the large scale producer, therefore, who can utilise new machines fully for the production of a large output. Besides, a large scale producer with his large resources can purchase every new machine that comes to the market and can himself spend money for encouraging research and experiment.

A producer on a large scale can buy his materials from the cheapest market and can get also good quality. He can utilise those waste products which are generally thrown away in a small factory, and can turn out what are known as the by products.

Besides these three broad categories of economies, a producer on a large scale finds it possible to spend a large amount of money in advertising. Sale of the output has developed into a scientific art at the present day and it is only the large scale producer who can get the full benefit of this new development. He spends much, but also sells much, and on the whole his cost per unit for advertisement and sale is lower than that of his smaller rival.

All these benefits combine to secure to the large scale producer the operation of the law of increasing returns with the attendant lowering of the cost of production per unit. Moreover, when a number of firms of the same sort have developed within a small area, 'external economies' will develop and the large scale producer will be able to

share these in addition to the internal economies enjoyed by him.

✓Q. 24. Discuss the disadvantages of large scale production. (*B. Com., 1923, 1925.*)

The disadvantages of large scale production generally arise from excess—in development, in division of labour, in marketing complexities and in the utilisation of machinery. A particular business may grow so large in size that it will be impossible for any individual to manage it. In Taussig's words, difficulties and limitations may grow on account of the 'infirmities of human nature.'

Excessive division of labour leads to dependence on paid managers who cannot be expected to take any personal interest in the work and also to a widening of the gulf between labour and capital which is the cause of labour unrest and discontent. The increasing complexities of the marketing system under large scale production causes a loss of direct touch between the producers and the consumers.

Again the loss of direct touch between producers and consumers is responsible for the ever-recurrent maladjustment between supply and demand and for the disequilibrium that is often brought about by sudden fluctuations in demand.

And lastly, we may note that the system of large scale production has generated a number of social evils arising from the huddling together of a large number of labourers in insanitary

dwelling employment of women and children prevalence of vices among labourers and the general demoralisation of the labourers

Q 25 Indicate the limits of large scale production in (a) manufactures and (b) agriculture ( *B Com 1938* )

Q What are the limitations to the increase of scale in the case of agriculture and other allied industries? ( *B A 1916* )

Large scale production is possible in any industry where machines can be used and division of labour brought into operation and there is surely some scope for increasing the scale of operations in agriculture and other extractive industries In modern agriculture and mining machines of different sorts can be utilised and to that extent the economies of large scale production can be secured

Difficulty of  
minute division  
of labour

But there is a limit to the scope of large scale operations in agriculture A very minute division of labour is not possible in agriculture and consequently the full benefits of large scale operation cannot be reaped Large scale agriculture would again mean the cultivation of a very large area of land and this would increase very much the difficulties of supervision and management The most important limitation to the increase in the scale of pro

duction in agriculture comes however from the dependence on nature that agriculture entails Whenever nature plays a dominant part in production the law of diminishing return operates and in agriculture in spite of various sorts of attempts to check this tendency nature ultimately dominates and limits the scope of large scale operations

Dependence on  
nature

Even in manufactures there is a limit beyond which it is not profitable to carry expansion further. For some time it is possible to check the operation of the limiting forces of nature by machines and by proper organisation of labour and resources. But as the scale increases, difficulties accumulate and it is found that there is a limit to expansion. Raw materials gradually become rare and costly, management becomes insuperably difficult, cost of expansion grows and because of the difficulty of securing a parallel increase in the availability of all resources, maladjustment in the factor-combination ultimately results. Even in manufacturing industries therefore there is a limit to the expansion on the size of a business unit.

This limit comes also for another reason. The competition among a number of rival firms gradually leads to the elimination or absorption of the weaker ones by the stronger ones. This process continues until only two or three firms are left, each very strong but each incapable of ousting the others. It is at this stage impossible for any one of these firms to expand further and to cut into the field of the others. Thus the monopolistic competition resulting from free competition brings the size of the individual firm to a limit after which further expansion is impossible. The expansion of the size of each is limited by the size of the others.

Q. 26. In what circumstances is small-scale production more economical than large-scale production? (*B. Com., 1930, 1933.*)

Q. Why does the small scale producer still persist in many industries? (*B. A., 1940.*)



Q On what grounds has it been held that the small firm has advantages of its own to set against the obvious economies of large scale production ? ( *B Com., 1912* )

In spite of the development of the large-scale methods of production, small scale producing persists in many branches of industry. In making goods requiring artistic skill, in the case of goods having a small clientele, in the case of retail shopkeeping operation on a small scale is still largely prevalent. This is due first to certain drawbacks and shortcomings of the large-scale system and secondly to certain positive advantages of small scale operation.

|  |   |
|--|---|
| Shortcomings of large scale production | Under large scale production only those things can be turned out which have an appeal to the masses, that is, which are cheap and popular. There are things the production of which requires the skill of the human hand and the consumption of which is limited to a few. In these industries the small scale system alone can be of any meaning and this explains why small scale production still persists in industries like embroidery work, jewellery, ivory carving etc. |
|  |   |

|                                      |  |
|--------------------------------------|--|
| Advantages of small scale production | A small scale producer can easily meet his customer's individual demand. He can take orders from each individual customer separately and make things to the specifications given to him. The tailor at the street corner, the shoemaker of the village, the small scale weaver—all survive the present industrialisation because of their ability to individualise their production or services. |
|                                      |  |

Besides, a small scale producer can secure economies to some extent. The cost of supervision and management is low and particularly because of "the master's eye being everywhere", the supervision is better done. The personal interest of the small-scale producer in his own business is certainly much greater than the interest that can be secured by payment of salaries to managers and supervisors.

Q. 27. Large scale production will inevitably replace small scale production in most branches of industry. Explain.

There are philosophers and social reformers who advocate a return to the pre-Industrial Revolution economic life on the ground that the factory system has been productive of a number of evils. It can however be pointed out that human wants are rapidly progressive and therefore the means of production have to adapt themselves to this. So long as human wants remain extensive and continue to be more so, production on a large scale will inevitably replace production on a small scale. The evils of large scale production can to a large extent be remedied—by social legislation, factory laws and greater liaison between the employers and the employees.

This does not however mean that small scale production would entirely disappear. Small scale operation would certainly persist in satisfying 'personal' demand or demands for articles consumed by a few only, while the large scale system will supply all the common needs of the people.

Q. 28. What are the influences that have brought about the concentration of industries in particular localities?

Indicate the chief advantages (and drawbacks) of such concentration ( *B Com, 1937, 1934* )

✓Q What are the chief causes of localisation of Industry ? Mention the chief consequences of such localisation ? ( *B A, 1923 1927, 1921* )

By localisation of industry we mean the concentration of particular industries in particular areas resulting from a geographical division of labour. This geographical division of labour arises either from the natural differences between one place and another or on account of differences that are created by the fact of concentration.

In pre-recent history we find many examples of concentration of industries in particular areas resulting from political causes. The patronage of the court of a ruling chief could often attract artisans to the capital city and this explains why Dacca, Murshidabad or Krishnagar became centres of weaving in Bengal or why the western part of the U P—the cradle-bed of Mughal Imperialism—developed a number of artistic handicraft industries. The mechanical skill of Lancashire is due to the influence of Hugo de Lupus in the 11th century, and the weavers of England were mostly Flemish and Huguenot artisans who left France on account of persecution.

The political causes however, play only a minor part in determining localisation in our times. Physical causes, including climatic factors play some part in the case of a few industries. The concentration of the jute growing industry in Bengal can be explained by the physical configuration and rainfall.

of lower and eastern Bengal. The tea industry has developed in areas geographically suitable for its growth, and the cotton mill industry has developed in damp areas like Bengal and Bombay or Lancashire, because a damp climate is particularly suitable for cotton spinning and weaving.

The most important factors leading to concentration are, however, purely economic. Industries concentrate in areas where raw materials are easily available, where a cheap and regular supply of fuel can be had, where the labour supply and banking facilities are adequate and where markets are either near at hand or easily approachable by rapid means of communication.

Psychological causes also are active in some cases. When an industry has already been to some extent concentrated in a particular area, further concentration will almost automatically take place. The fact of concentration no doubt gives rise to certain new advantages or external economies; but the momentum of the start also produces an inertia towards concentration which a new-comer can very rarely overcome.

This localisation of industries has both advantages and drawbacks. The advantages can be all summed up in short by stating that localisation increases the fund of external economies—economies that become available to any one who comes to the particular locality for starting a factory. Subsidiary industries develop for supplying materials to the main industry or for further utilisation.

tion of its products    Means of communication develop

Skilled labour    The labourers in the locality come to acquire a hereditary skill in their work and they find a local market available for employment of their labour

Inventions and improvements    Localisation also increases banking and financial facilities and, by promoting a healthy rivalry between neighbouring factories, encourages inventions and improvements in machinery and in the technique of production

Among the drawbacks we first note that too much concentration may mean congestion and difficulties in providing dwellings for the labourers

Drawbacks    Much more important than this is the fact that a district which is chiefly dependent on one industry is liable to extreme depression in case of a falling off in the demand for its produce or of a failure in the supply of the raw material it uses

Congestion and difficulties    The recent distress in Lancashire has been due to the fact that the whole district came to depend on the cotton mill industry, but the demand for the output of this industry declined

Too much dependence on one industry    Moreover, too extensive a demand for one kind of labour may make it impossible for women and children to get employment or for labourers to develop their individual faculties

Demand for only one kind of labour

**Q 29** Why is the jute mill industry of this province (Bengal) localised in the neighbourhood of Calcutta and not in the jute growing areas of Eastern Bengal ? (B A, 1929)

An industry (as we have seen) is localised in a particular

area into which political, physical and economic causes lead it. It may be difficult to find out a single area where all conditions are favourable and therefore the industrialists have to select a place where a majority of the determining factors are present. Thus from the standpoint of easy availability of raw materials, Narayanganj, Mymensingh or Sirajganj would appear to be the places most suitable for the jute mill industry. But the centre of this industry has been the neighbourhood of Calcutta because of the easy supply of coal and of labour and capital, and because Calcutta is connected by good means of transport with all parts of India and of the world outside. The momentum of start has also been responsible for the concentration of the industry in this area. The first mill was started at Rishra near Calcutta and ever since the mills have centred round this zone.

Q. 30. What harmful effects follow from an excessive division of labour between persons and places ? (*B. A., 1930.*)

The main object of division of labour is to secure an increase in output by making the best possible use of the efficiency of the labourers. The advantages of division of labour need no recounting ; but it has always to be borne in mind that if division of labour—either between persons or between geographical areas—is carried to an excess, the expected economies may disappear and positive diseconomies may ensue.

Excessive division of labour between persons may result in such complication in the structure of organisation that it would be impossible to secure an organic development of the economic system as a whole. From the standpoint of the labourers, such excessive subdivision may

Excessive divi-  
sion of labour  
between persons

lead to a number of inconveniences. If a particular labourer has got to repeat many times a day and every day in the year the same operation, his life becomes dull and monotonous and his intellectual life is dwarfed. As he does not produce any complete thing he ceases to have any pleasure and pride in his work.

Moreover, excessive subdivision means that a particular labourer learns only one work or a part of a work. If for any reason the demand for that kind of labour diminishes, the labourer will have to suffer from unemployment. To some extent, however, this evil has been mitigated by the fact that machines used in one industry are often similar to those employed in another, enabling labourers to pass from one industry to another.

Territorial division of labour, if carried to an excess will also produce similar results. An area dependent only on one industry will fall in great difficulty if there is ever any depression in that particular industry. It is because of this that some 'diversification of industries' though uneconomic, is desirable for every country. Excessive territorial division of labour also produces other evils like providing no employment for any but one particular kind of labour, creating congestion and overcrowding etc. and producing a bit too much of interdependence between one area and another—an interdependence which may be disastrous when trade and communications are cut off by, say, a war.

Q 31. What are the functions of the entrepreneur? Estimate his importance in the modern economic organisation. (B A 1943)

Q. Indicate the important economic functions performed by the mercantile class. (*B. Com., 1932.*)

Q. What do you mean by Organisation of Production? Is a merchant, a speculator, or a banker an organiser? (*B. A., 1941.*)

If production is to be efficiently carried on it is not enough to bring together a large quantity of each of the factors. The factors have to be combined in right proportion and it is only where an appropriate factor-combination has been reached that production will be at the optimum point. We

Co-ordination of the factors give the name *organisation* mainly to the function of co-ordinating the different factors of production, of combining the factors

in such proportions that the maximum of output can be secured from a given amount of resources. The determination of the appropriate combination is an art that can be picked up only by trial and experience and the expert organiser has, therefore, to undertake full responsibility for the purchase of raw materials, borrowing of capital, employment of labour, running the factory, and finally selling the output.

The function of co-ordination and management is generally associated with the taking of risks, and bearing of uncertainties. In every business there are

Risk and Uncertainty certain risks; these risks can sometimes be anticipated and allowed for, *e.g.* in insurance against fire. There are also some entirely unforceable

uncertainties and the entrepreneurs or organisers must be prepared to take upon themselves the uncertainties associated with business. Though risk-taking and uncertainty-bearing can often be separated from organisation proper, these all



generally go together and the term organisation, in its wide sense includes not only factor co ordination and management but risk taking and uncertainty-bearing too. The name *entrepreneur* is generally given to the person who undertakes these two functions.

If the term organisation is taken in this sense and if production is taken to mean any service that satisfies a social want, merchant, a banker and a speculator are all organisers of production. A merchant brings together the resources necessary for his operation and takes risks and uncertainties, the speculator has to organise his purchases and sales and assume the risks so inevitably connected with his business. A banker also has to organise his resources and there is practically no difference in nature between his services and the services of a merchant or an industrialist.

The services of the merchant are very important these days. A merchant is one who buys things from the place where and at the time when it is available, stocks them and sells when and where required. His work requires great powers of organisation and watchfulness and particularly of correctly anticipating the future. If production is taken to mean merely turning out material things, a merchant is not a producer. But if production means any service that adds to the sum total of satisfaction in society the merchant is as much an organiser of production as anybody else.

So long as the system of production remains capitalistic, the importance of the factor-coordinating and risk bearing

entrepreneur cannot be minimised. Most men are either incapable or unwilling to take up the function of organising production even though the incentive of profit is present. It is the entrepreneurs who make the plans for production, allocate resources, bring out supplies in response to demand and distribute their supplies over large areas. The system under which capitalists and business-men hold the key is open to grave objection, but so long as the system is there, the entrepreneur cannot be dispensed with.

Q. 32. What are the different ways in which capital is organised ? ( *B. A., 1924.* )

Q. Compare the merits and defects of the following types of business organisation : (a) private firm, (b) joint-stock company and (c) co-operative enterprises ? ( *B. Com., 1943.* )

One of the most important problems of industrial organisation is that of collecting a sufficient amount of capital. When the scale of business is small, the amount of capital required may be small enough to be supplied by one single entrepreneur. Under this *private firm or single-entrepreneur system*, business organisation is simple ; one single individual supplies the whole of the amount of capital required, manages the unit, takes the gains and bears the losses.

The evolution of organisation has, however, been towards an expansion of scale requiring larger amounts of capital every day. When the single-entrepreneur system failed to supply adequate amounts of capital, *partnership* was naturally evolved ; a small number of persons, usually two or three, jointly supplied the capital,

were jointly responsible for management, were jointly as well as individually liable for the debts of the business and lastly, were joint participants in gains and sharers of losses

With the growth of factory production partnership proved wanting. The amount of capital required in a modern business is very large and it is not often possible for a small number of individuals to contribute it. Besides a partnership often lacks in continuous operation, the death or withdrawal of a single partner is enough to cause a dissolution. The most important defect of partnership is, however, the absence of any limitation on the liability of an individual partner. Each partner being individually liable up to an unlimited amount, a partnership is often dangerous for a solvent man particularly when his partner is unscrupulous and dishonest.

Out of the imperfections of the partnership system grew the modern form of organisation known as the *joint-stock form*. Under this system the whole of the nominal capital required is divided into a large number of shares, each of a small value, and individual investors are invited to purchase these shares. The shareholders thus are the owners and risk takers of the firm—but their risk is limited by the '*Limited Liability*' provision under which a shareholder who has once paid the full value of the shares purchased cannot be made to pay anything more. If the capital supplied by the shareholders is insufficient, a joint stock firm may borrow capital from a bank, or, in the alternative, it can borrow from the public in the shape of small units known as *debentures*.

Defects of  
partnership

Joint-stock  
business

Limitation of  
liability

The business of joint-stock firm is generally large and it is carried on by paid officers and workers working under a Board of Directors who in their turn are elected by and responsible to the general body of shareholders.

Side by side with the development of the joint-stock system, there has grown up another system of organisation known as *Producers' Co-operation*. The joint-stock system creates a gulf between the owners of business and the actual managers and also between the managers and the labourers and there arise from this, problems of discontent and of proper sharing of the proceeds. By producers' co-operation we mean an identity of the owners, managers and the labourers. If a number of workers combine together and collect a small amount of capital and then run, manage and work in their own factory, we get productive co-operation. The profits are pooled for the workers themselves and the entrepreneur is eliminated. It is apparent that this system of productive co-operation can be successful only when the scale of operations is small. In the case of a large scale unit the expert entrepreneur cannot be eliminated and the joint-stock system has to be adopted.

/ Q. 33. Discuss the advantages and limitations of the joint-stock form of productive enterprise. ( *B. Com., 1936, 1927.* )

Q Discuss the advantages and weak points of joint-stock companies. ( *B. A., 1933.* )

The greatest advantage of the joint-stock system is that it alone makes possible the present day form of the industrial organisation. The large scale business of our times requires first of all a large amount of capital, secondly con-

Collection of a large amount of capital

tinuity of operations and thirdly some limitation upon the liability of those supplying capital. A joint stock business

**Continuity of operations** makes possible the collection of a huge amount of capital by enabling a large number of small investors to pool their savings together. Continuity of operations is secured by making the shares 'impersonal and easily transferable from one

**Transferability of shares** person to another. Investments that are fixed for the community as a whole are thus rendered liquid for the individual and this acts as a protection to the individual shareholder.

**Security for the shareholder** Further protection is granted by limitation of liability. We may note also that the easy transferability of shares leads to division of risks and also to a tendency towards concentration of ownership and management in the hands of the shrewd and the competent.

On the other side the joint stock system is not without its limitations. The wide separation between the owners or the shareholders and the actual managers opens up immense scope for fraud and corruption. directors and managers possess

**Scope for corruption** ing inside information can easily defraud the shareholders who get information about their company's affairs only once a year. The shareholders as a result

**Indifference of shareholders** are mostly indifferent and impotent and consequently, real power is exercised by the directors. Labour troubles are generally frequent in joint stock business because of the absence of any contact

**Labour troubles** between the owners and the employees. In conclusion we may note that the transfera-

bility of shares leads to a number of advantages no doubt, but it also makes stock exchange speculation possible. This stock exchange speculation is productive of a number of evil results and some of the major crises of the recent past owe their start to it. Besides, it is the joint-stock system that has accentuated the present day tendency towards combination and monopoly.

It should, however, be noted that it is the joint-stock system that has made the present day industrial organisation possible. If capital-using production is to be reconciled with any social system short of socialism, the joint-stock method is the only possible method of business organisation. Marshal would say that the present day system is rendered possible by the growth of business morality : to a large extent, however, the evils of the joint-stock system are still there and there have been in every country attempts to check these evils by restrictive legislation.

Q. 34. Discuss the merits and defects of monopoly industry. (*B. Com.*, 1929.)

Q. Describe the various forms of combinations among producers. Discuss their economic effects. (*B. A.*, 1914, 1927, 1922.)

✓Q. What are Trusts and Cartels ? Examine their merits and demerits. (*B. A.*, 1945.)

When producers owning individual units of business find that they have reached the limits of expansion of the *scale of production* they can still expect to gain further economies by expanding the *scale of management*. This can be secured

by means of combination which may be of two broad types  
When a number of business units exactly alike in the nature  
of the work done and competing freely with one another

combine together, such combination is  
Horizontal and known as *horizontal*, when a combination  
Vertical combination is formed among a number of units produ-  
tion cing different commodities related to each

other in such a way that one is necessary for the production  
of another, the combination is *vertical*. Thus a combination  
among a number of cotton mills, or among a number of sugar  
factories would be a horizontal one, while a combination  
among an iron mine, a coal mine, a manganese mine an iron  
smelting factory, a steel factory and an engineering concern  
would be vertical combination

A horizontal combination aims at securing the advantages  
of large scale management particularly in purchase and sale,  
Advantages and secondly at monopolisation. A vertical  
combination aims at eliminating the middle-  
men's profits and assuring a continuous supply of raw  
materials and ancillary materials to the main industry, at  
the same time providing the former group with a steady  
demand. A combination can also secure economies by eli-  
minating the wastes of competition and contribute towards  
mitigation of industrial fluctuations

The horizontal combination may be of different degrees  
Forms of combi or grades. The commonest type of horizontal  
nation combination is the *Trust* or a federation  
Trust of firms, each making over its power of  
control to a common body of trustees. The firms that com-  
bine into a trust lose their separate legal existence, and the  
common management that is instituted comes to have com-

plete control over every matter connected with production and sale. Trusts originated in the U. S. A., and in some form or other have spread practically all over the world.

The German form known as *Kartel* is a loose organisation mainly attempting to maintain monopoly power but not directly interfering in the internal management of the component firms. The combining firms do not lose their separate existence and autonomy. They merely agree to delegate some matters of common interest to the common organisation instituted. Generally a *Kartel* aims at regulating and rationing of output or at controlling prices, through a single selling bureau for the whole industry.

*Pool* is the name given to any arrangement for limiting competition. In the U. S. A. after Trusts were made illegal by the Sherman Anti-Trust-Act of 1890, a new sort of organisation known as *Holding company* *holding companies* was formed. A holding company would hold shares in large numbers of the companies wanting to unite and would thus secure unity without directly appearing to have done so. The limiting form of combination is no doubt a complete *Fusion or Merger* under which a brand new organisation replaces the pre-existing ones and the latter lose their identity in the former.

We have already indicated the possible gains from industrial combinations. We find, however, that sometimes a combination may cause great fluctuations rather than avoid these. "It is quite conceivable", says Taussig, "that it may intensify rather than mitigate fluctuation. A gambling promoter and a patched-



up combination an attempt to raise prices and profits, sudden puncturing of the inflated enterprise and a collapse on the stock market, these are familiar episodes of recent times" From the standpoint of the consumer the greatest danger of combination is that an artificially high price may be sought to be maintained—if necessary, even by dumping of surplus stock abroad. And examples have not been rare when combinations controlled by powerful businessmen have corrupted political life by inducing the government or the legislature to act in the interests of the businessmen and against the interest of the people.

✓Q 35 Discuss the causes favouring the formation of trusts. What in your opinion is the best means of minimising the evils associated with trusts? (*B Com.* 1942, 1935)

Trusts can be formed only when industrial development has proceeded far enough to expand sufficiently the scale of operation in the individual unit of business, to make process and technique almost standardised, to widen the market and to have brought about some amount of localisation of industry. If there is an Economy of large scale production anticipation of a greater volume of economy from expansion we may hold that the first condition favouring the formation of a trust is present.

The second cause favouring the formation of a trust is the expectation of positive benefits from the expansion of the scale of management. There are certain Economy of large scale management technical and structural economies that large scale management can secure and the producers joining a trust are naturally stimulated by the desire to secure these.

The most important cause of formation of trusts is the desire to secure monopoly gains. These monopoly gains are likely to be highest when the demand for the commodity is inelastic or when, what is more important to the producer, the cost of production decreases sharply with an increase in output. We can, therefore, hold that any cause that makes demand inelastic or makes cost decrease is a cause favouring the formation of a trust.

Attempts to check the evils of trusts by legislation have mostly failed. In the U. S. A. an Anti-Trust Act was passed in 1890 but shrewd businessmen evolved a number of methods for evading the law. It has now come to be recognised that it is not possible to prevent combinations from coming into existence by means of legislation. All that can be done is to regulate their activities. Laws can be made for regulating capitalisation, rate-cutting, preferential rates and rebates, and for fixing prices and profits. Rationalisation of industries by which we mean a policy of elimination of wastes through combination together with one of maintaining stability may go a long way. Scientific rationalisation combined with sound laws may, to some extent, check the evil effects of combination.

✓ Q. 36. Consider how far the cooperative form of business organisation is an improvement upon the joint stock type. (*B. Com., 1945.*)

Though the joint stock type is the most common form of business organisation, its limitations and shortcomings have led many to favour the cooperative type of management. In

a joint stock company the legal owners are the shareholders but real power does not and cannot be exercised by them. A class of persons, known variously as managers, managing directors or managing agents control everything and practically all the evils of capitalistic production emerge from the divergence between legal ownership and real control and that between ownership and work. In the capital market, the joint stock system has led to the concentration of control in the hands of a small number of financiers and to speculation, in the field of labour the joint stock system has led to conflicts of interest between the owners and the workers.

The cooperative system, it is claimed, will be free from all these defects. The workers managers and owners will all be identical and so there will be no scope for any divergence of interest. If ten weavers would combine their resources for establishing a cooperative weaving shed and then work themselves as labourers, wages, interest and profits would come to the same hands and most of the problems of present day productive organisation would disappear. On this ground it is argued that a widespread development of cooperative production would produce a type of business organisation superior to the joint stock system.

There are, however, two important limitations that make such a programme unpracticable. First, the cooperative system is particularly suited to small scale production. If large-scale production has to be developed, cooperative management would prove unwieldy. Secondly modern production requires the services of technical experts and also of expert managers and entrepreneurs. The cooperative system seeks to do away with this specially trained class of persons and it is evident that that this will mean failure at least in

those industries in which high-grade technical and managerial skill is indispensable.

Q. 37. Explain carefully the laws of Increasing, Decreasing and Constant Return. (B. A., 1922.)

The most universal fact regarding the relation between the resources employed and the returns secured is that the optimum return is obtained when the most appropriate combination of factors of production is put into operation. It

is difficult to discover this optimum of  
Optimum factor-combination factor-combination and every producer

has to find it out for himself by trial and error. So long as this optimum is not reached, any increase in the quantity of the deficient factor would lead to increasing returns; and when the optimum has been crossed, any further application of a particular factor would disturb the combination and diminishing returns would follow.

In manufactures there are immense possibilities of securing economies from capital and organisation by an expansion of the scale of operations. Returns go on increasing at a more than proportionate rate with every increase in the amount of capital, and hence of labour employed, and cost of production per unit of output falls.

There will, however, sooner or later, come a stage when a further increase in the amount of capital employed would

make the firm unmanageable, i. e. the  
Difficulties of management organisation-factor would be inadequate in comparison with the capital-factor, and

after this stage diminishing returns would be obtained. Even in the earlier stages, if the amount of capital goods employed is increased without increasing at the same time

the number of labourers employed, increasing returns would cease

In agriculture, diminishing returns is the general rule, because an increase in the amount of labour and capital is unaccompanied by an increase in the land-factor. Increasing returns may be experienced in agriculture when the amount of labour and capital already being applied is inadequate for full development of the powers of the soil, in such a case, a further application of capital and labour would mean a nearer approach to the optimum factor combination, and hence returns would go on increasing until this optimum is reached

The operation of the law of constant returns is in most cases nothing more than a theoretical possibility. In the same industry, one part of the work may be done under conditions of diminishing returns or increasing cost, while another part of the work may be done under conditions of increasing returns or decreasing cost. In the flour making industry, for example, the cost of wheat would gradually increase with an increase in output, while the cost of turning wheat into flour would gradually fall. If the increase in one part of the cost is just neutralised by the fall in the other part, we get on the whole, a case of constant cost or constant returns. Such cases, however, are rare and in actual experience we get either diminishing returns or increasing returns

✓ Q 38 'Broadly speaking while the part which Nature plays in production conforms to the law of Diminishing Return the part which man plays conforms to the law of Increasing Return. Discuss (B.A., 1932)

In every branch of production man and nature are

the two fundamental factors. To a certain extent nature is very generous—our resources, our energies, our means of communication all depend on what we get from nature. But nature's munificence is limited. Nature gives, but not without making it difficult to receive.

The part which man plays in production consists, first, in utilising fully all that can be secured easily from nature, and secondly, in overcoming the limitations set by nature. In so far as man is successful in securing both of these objectives, he would be able to secure increasing returns.

In manufactures the dependence on nature is of minor importance and all scientific inventions have been directed to the overcoming of the limitations and obstacles set by nature. In agriculture, on the other hand, the dependence on nature is great and scientific inventions have not yet been perfected so much as to be able to overcome the effects of this dependence. Naturally, therefore, man plays a comparatively subordinate part in agriculture, while nature dominates, and the consequence is that human attempts to secure larger outputs are not rewarded by even proportionate increases.

Even in manufactures, the law of increasing returns operates only so long as man is able to overcome the obstacles set by nature. The thrust of nature, however,

always continues, and a stage may come when the accumulated obstacles become so great as to be unconquerable. Raw materials may become scarce, power resources may be inadequate, the strain on labourers' muscles and nerves may become unbearable, and the work of management may

become too complicated for being coped with by normal human intelligence. Here again, nature begins to play a dominant part and manufacturing industries begin to show a tendency towards diminishing returns. So long, therefore, as man dominates over nature, production follows the law of increasing returns, and when nature dominates and man plays a comparatively minor part, the law of diminishing returns would operate. This principle is as true of agriculture as of manufactures.

✓Q 39 Explain why an increase in the volume of production, whether in the single firm or in the trade, usually brings with it a decreased cost of production per unit (B Com., 1945)

In a manufacturing industry an increase in the output of a single firm usually means a reduction in the output. This is due first to the general economies of large scale production. An increase in output is generally sought to be secured through an increased use of machinery, or use of better machinery or improved organisation of labour. In any case, an expansion of the scale of production will bring a lowering of the average cost of production, because of the economies of machinery, skill and materials that would be available.

Besides an increase in output does not mean an increase in every item of the cost of production. There are some items, as managers salaries, interest on capital, etc., which remain unchanged when there is an increase in output on a moderate scale. The part of the cost is known as *supplementary cost*. There are other items, known as *prime costs*, which vary with every change in the output, e.g. cost of raw

materials, wages of labours, packing and transport charges, etc. Now, an increase in output means an increase in the prime costs only, while the supplementary or over head costs remain more or less fixed. This partial fixity of the cost-schedule means that average cost will decrease with every increase in the output.

In the trade as a whole, an increase in the volume of production leads to the growth of external economies. Localisation of industry gets an impetus, new inventions are encouraged, new means of communications develop and the keenness of competition encourages every producer to economise at every possible point. Broadly, therefore, it may be said that an increase in the output causes internal economies in the individual firm and external economies in the industry as a whole and thus the result in either case is a lowering of the cost per unit.

Q. 40. Write short notes on (a) External and Internal economies, (b) Rationalisation, (c) the Entrepreneur.

(a) By External economies we mean those economies that arise from the general development of an industry, and in which every firm can share. These External and Internal economies arise very largely from localisation of industry. If, as the result of localisation in a particular area, means of communication develop, subsidiary industries grow or labour becomes efficient, these advantages would be available to all entrepreneurs and these can, therefore, be regarded as external economies. Internal economies, on the other hand, are dependent on the resources of an individual house or business. The internal economies of a firm are its own



and these will naturally be different from the internal economies enjoyed by another. If a particular firm uses a particular organisation of labour and of processes, or a particular technique of production or a particular set of machines, these would be economies internal to the firm.

(b) Rationalisation is the name given to the method of technique and organisation designed to secure the minimum of waste either of effort or of materials. It includes a number of lines of action, e. g., standardisation of materials and products, simplification of varieties, reduction of waste, scientific management, use of specialised machinery, combination, etc. Rationalisation as an industrial policy became popular first in Germany where post-war re organisation was found full of obstacles, and later spread in the U S A and other countries.

(c) The Entrepreneur is the person who supplies the factor of organisation, risk-taking and uncertainty-bearing. The main work that he had to do is to co-ordinate the different factors of production, & to bring them together in right proportions. In doing this he requires a very high degree of ability, and this is why entrepreneurs of the first order are very rare. An ideal entrepreneur, says Marshall, must have a thorough knowledge of men and of things and must be able to judge cautiously as well as to undertake risks boldly.

Q 41 Name four articles which you consider to be inelastic in supply. Give reasons in each case (B A, 1943)

Elasticity of supply means responsiveness of supply to changes in price, and it can be measured by the ratio be-

tween the degree of change in supply and the degree of change in price. If a slight rise in price causes a great increase in supply or slight fall in price reduces production considerably, supply can be regarded as highly elastic. An inelastic supply will be experienced when production does not change appreciably as the result of a change in price.

Land is a good example of a commodity of which the supply is inelastic. Though it is possible to change the supply of land for one particular purpose in preference to another, the total supply of land in any country is fixed. Some increase can be made in the *available* supply through reclamation or deforestation, and some reduction in the available supply is perhaps possible if some areas are allowed to fall into disuse. But the effects of all these are on a minor scale, and it is generally true that the supply of land is inelastic in its response to changes in the price of land.

Another good example is gold. New supplies of gold is such a small part of the total stock available in the market that price depends upon the accumulated aggregate of past production and not upon current output. Small changes in the price of gold do not materially affect the *total* supply of gold in the markets of the world.

Non-reproducible articles provide us with many illustrations of inelastic supply. There is only one copy of the original painting of Mona Lisa by Leonardo da Vinci. Changes in the price of this painting will not cause any expansion or contraction in its supply.

Lastly, human labour is a commodity of which the supply is often inelastic. Supply of labour as a whole or of highly specialised labour in a non-competing group does not respond

easily to changes in the prevailing wage rates. A fall in the wages for manual labour will not reduce at once the supply of such labourers, and a rise in doctors' fees will not immediately increase the supply of doctors.

## CHAPTER V

### Exhaustion Value — विनिमय :-

1

Q 1 The theory of prices may be regarded as the central problem of economic study forming the key to the understanding of all other economic phenomena. Discuss (B Com., 1933)

In economics the theory of value is of fundamental importance. If economics is defined as the science of material welfare its central problem naturally is the measurement and comparison of the power of different commodities to yield welfare and this can be done only by evaluating one thing in terms of another, or things in general in terms of a common standard of measurement. This evaluation is constantly being done by everyone of us, when we get a thing we have generally to sacrifice another and in doing so we have to measure the value of one in terms of the other. The theory of value is merely an analysis of the forces that determine and underlie the process of valuation. These forces are partly subjective depending on the psychological reaction that the possession or loss of a commodity can produce, and partly objective, depending on the

Value and Welfare

technique of production and the availability of resources. These forces affect different problems of value in different degrees and the economist has to find out the general principles emanating from the interplay of all or some of these forces.

In a sense, every important economic problem is a deduction from the central theory of value. The whole of the theory of distribution is only an application of the theory of value for determining the forces underlying the social evaluation of the services of land, labour, capital and organisation. The theory of the value of money, the theory of international trade, the theory of incidence of taxes and of bounties are all corollaries derivable from the theory of value.

✓ Q. 2. Define the term 'market'. What are the chief conditions which a commodity must satisfy to have a wide market? State with reasons what you would expect to be the extent of the market for bricks, fresh vegetables and precious metals. (*B. A. 1920.*)

The word 'market' is ordinarily used to mean a place where buyers and sellers meet. In economics the word is used to signify the whole range of operations between the buyers and sellers of a particular commodity, and is not consequently confined to any specified locality. The definition given by Cournot is perhaps the best: Economists, says he, understand by the term 'market' not any particular market place in which things are bought and sold, but the whole of any region in which buyers and sellers are in such free

Cournot's definition

intercourse with one another that the prices of the same goods tend to equality easily and quickly

The market for some commodities is wide and for some it is very narrow. Generally speaking the market is wide for commodities for which there is a large demand and which are capable of being easily and exactly described. If the articles are such that can be represented by samples or easily graded into standard types, the market is likely to be wide. Besides, commodities can have a wide market if they are easily portable, fairly durable and contain a large value in a small bulk. Gold, silver and stock exchange securities of the highest group satisfy all these conditions and have, therefore, a world-wide market, on the other hand, bricks and fresh vegetables have very narrow markets because they are not easily portable, nor durable, nor do they contain a large value in a small bulk.

Q. 3 Distinguish between value and price and inquire whether there can be a general rise of values and a general rise of prices (B A 1921)

The word value is used in Economics to denote the power which a commodity has got of commanding other things in exchange. These "other things" can be chosen from all commodities we see around us and, therefore value can be expressed in terms of any and every commodity. As it is inconvenient to express values of commodities in terms of one another, it has become usual to measure all values in terms of money and when this is done, value

is called price. Price, therefore, is the value-in-exchange of a commodity expressed in terms of money.

From the above, it appears that there cannot be a general rise (or fall) of all values while there can be a general rise or fall of prices. If by value we mean a ratio between one commodity and another, the rise in the value of a table in terms of chairs would automatically imply a fall in the value of chairs in terms of tables. All values cannot, therefore, rise together or fall together. A general rise or fall in prices is, however, possible, and probable too. When the supply of commodities is too large as compared with the amount of money people are willing to spend, all prices will fall and the reverse will happen when people offer a large amount of money but goods are scarce. A general fall or rise in prices, therefore, can take place (bringing about, of course, a rise or fall in the *value of money itself*).

Q. 4. Water is more useful than gold; yet gold has a greater market value than water. How do you explain this paradox? (*B. A., 1932.*)

Q. Iron is more useful than diamonds, yet diamonds are incontrovertibly more valuable. How would you explain this? (*B. A. 1927.*)

The value of a commodity is, no doubt, largely dependent on the utility of the thing. At least, we can definitely show that though a commodity having utility may have no value in the market, some utility is essential if there is to be any value. Value, however, is never proportional to utility. The reason is that the supply of a

Value not  
proportional to  
utility

commodity has a very important influence on value. Water may be more useful than gold but water is at the same time available in almost unlimited quantities while gold is very scarce. It is this scarcity of gold that makes its market value high. In the same way though iron is more useful than diamonds the relative scarcity of diamonds and plentifulness of iron make the former more valuable than the latter.

We can give scientific precision to the remarks made above by stating that value depends on marginal utility and not on total utility. The total utility of water is infinitely large but its plentifulness makes its marginal utility low and price ultimately equals marginal utility.

On the other hand gold may yield a small degree of total utility but its scarcity makes its marginal utility high. The marginal utility depends not only on the want satisfying power of the commodity but also on the supply and the rate at which scarcity is approached. This marginal utility as Marshall says is no indicator of the total utility and this is why the value of a very useful thing may be low while the value of a less useful thing may be high.

✓Q 5 Examine the influences on the side of supply that determine value and show that the term cost of production bears more than one interpretation (B Com 1945)

The price of a commodity under given conditions of demand is dependent on the supply and more fundamentally on the factors governing the supply. It is not enough to say that a large supply will lower the price and a small supply will increase it. It is necessary to explain why the

supply of some commodities is large and that of others small.

Supply depends fundamentally on the availability and alternative uses of resources. The production of every commodity requires the combination of various types of resources like raw materials, fuel, labour, etc. The plentifulness or scarcity of these resources and the extent to which these can be diverted from other alternative uses determine the supply when conditions of demand are given. These influences operative on the supply side are reflected in what is called the "cost of production".

The term cost of production bears more than one interpretation. From the standpoint of the businessmen, cost of production means the actual monetary outlay made for the production of a commodity—including wages for the services of the producer himself. This '*money cost of production*' or '*expenses of production*' is directly effective in setting the lower limit to the price of the commodity produced. Sometimes, by cost of production we mean the efforts, sacrifice and pain undergone in producing a commodity. If wages in every case had measured the effort and strain of the labourer and if interest had measured the sacrifice of the capitalist in every instance, then this cost of production in terms of sacrifices or the '*real cost of production*' would have been correctly represented by the money cost of production. But this correspondence is rarely found.

Cost of production has been more recently conceived of as an aggregate expression of alternatives displaced as the result of producing some particular thing. So long as resources are limited and they have alternative uses, the production of any one thing means that some other things can-



not be produced. Thus while society gains from the supply of some particular commodity, it loses the opportunity of producing other things. This *opportunity cost* is the measure of the social loss to be set off against the gain from the production of anything.

It is however to be noted that to the businessmen it is the money cost alone that matters. The economist seeks a correspondence between money cost and real cost or between money cost and opportunity cost. The businessman takes into account his monetary outlay only and price in the long run is equal to the money cost of production of the marginal producer.

✓ Q 6 'Value supply and demand are interdependent'  
Explain this statement (B Com, 1931)

Q Explain how price is determined in a market under perfect competition (B A, 1939)

Q Show that the price of a commodity under perfect competition tends to coincide with the marginal utility on the one hand and the marginal cost of production on the other (B A 1945)

✓ Q Explain how unrestricted competition amongst innumerable buyers and sellers makes only one price prevail in a market (B A, 1942)

Price under competition is determined by the interplay of two sets of forces—one coming from the side of buyers and the other from that of the sellers.

Interdependence of value, supply and demand      Value thus is determined by demand and supply. But it should be remembered that demand and supply are not independent determinants of value—they themselves are affected consi-

derably by changes in value. A change in demand or in supply will cause a change in value, and on the other side any change in value will cause a change in demand as well as in supply. A rise in value will increase supply and reduce demand; a fall in value will reduce supply and increase demand. Ultimately as the result of this interdependence of value, demand and supply, value will come to be settled at the point where the amount demanded will be equal to the amount supplied.

On the side of demand, value will equal the marginal utility of the commodity. The marginal utility depends on the relative want-satisfying power of the commodity and on the number of units available. If the marginal utility is great, buyers will offer higher prices which will attract larger supplies. This increase in supply will lower marginal utility and ultimately the marginal utility will be equal to the price. To put it very briefly, buyers will buy more if marginal utility is greater than price, and will buy less if marginal utility is less than price. The effect of this on supply will lower the marginal utility in the former case and will raise in the latter case—leading ultimately to an equality of marginal utility with price.

On the side of supply, we find that usually a number of competing firms supply the same commodity. As entrepreneurs differ in ability and firms differ in efficiency of organisation, the cost of production will be different to the different firms. The price that is offered by the buyers must cover the cost of production of the least efficient among these firms whose outputs are

Demand side :  
Value equals  
Marginal utility

on the relative want-satisfying power of the commodity and on the number of units available. If the marginal utility is great, buyers will offer higher prices which

Supply side :  
Value equals  
Marginal cost  
of production

in efficiency of organisation, the cost of production will be different to the different firms. The price that is offered by the buyers must cover the cost of production

required to meet the effective demand in the market. If the price is lower than this cost, the least efficient producer will not produce, and, therefore, supply will fall short of demand; if the price is higher than this cost, the potential producers who are worse even than the above mentioned least efficient producer will begin to produce and consequently supply will exceed demand. Demand and supply will be at equilibrium only when price is equal to the cost of production of the least efficient among those producers whose outputs are required to maintain this equilibrium, i.e. to what we call the *marginal cost of production*.

In equilibrium demand must equal supply, for if demand exceeds supply, price will rise and if it falls short of supply, price will fall. At the point at which a stable price is secured, price equals the marginal utility on the side of demand and the marginal cost of production on the side of supply. If, with a given supply in the market, marginal utility is higher than the marginal cost, producers will find it profitable to bring more supplies. But this in itself will lower the marginal utility and raise the marginal cost, bringing them nearer to one another until they become equal. Similarly, if the marginal utility is less than the marginal cost, supply will be curtailed and this will again raise the marginal utility and lower the marginal cost. We may conclude, therefore, that under competition price is determined at the point where the amount demanded equals the amount supplied and where the demand price or marginal utility equals the supply price or the marginal cost of production.

Equilibrium  
Marginal utility  
equals cost of  
production at  
the margin

Q. 7. Analyse the effect of an increase in demand on prices over short and long periods. (*B. Com., 1938.*)

Q. Explain the importance of the time-element in the theory of value. (*B. A., 1937*). 4

In economics, as in other social sciences, we have often to distinguish between the immediate and the ultimate, or between the short period and the long period. A particular cause may produce a particular immediate effect but quite a different effect in the long period.

If, for example, there is an increase in the demand for a commodity, the immediate effect in every case will be an increase in price; the ultimate or the long period effect will, however, depend on the nature of the commodity, or more particularly, upon the way cost of production will behave as the result of increased production following the increase in demand. An increased demand will ultimately bring about an increase in production. This increase in production will raise the expenses of production in the case of an agricultural commodity produced under conditions of diminishing return, lower the expenses in the case of a commodity produced under the operation of the law of increasing returns, and will keep the cost stable in the case of a commodity produced under constant returns. Though the short period effect of an increase in demand will be to raise price in every case, the long period effect will vary; price will fall in the case of a commodity produced under increasing returns, rise in the

case of a commodity produced under diminishing returns, and remain steady at its old level in the case of a commodity produced under constant returns.

The importance of the distinction between the short period and the long period is most clearly seen in the relation between the market price and the normal price. The period taken under consideration may sometimes be so short as to make any adjustment of supply to demand impossible. If in such a short period a change in demand takes place, the supply will not be capable of being changed at once, and hence the demand side will be dominant in determining value. If, however the period of time is long enough to enable producers to adjust the supply to any change in demand, it is the cost of production of the marginal producers that will determine value. The long period demand is comparatively stable, and so a change in value will generally be caused by some change in cost-conditions. We may remember the general principle enunciated by Marshall "As a general rule, the shorter the period we are considering the greater must be the share of our attention which is given to the influence of demand on value and the longer the period the more important will be the influence of cost of production on value."

The importance of the time element is seen in other directions also. The most important of these is experienced in the distinction between prime cost and supplementary cost. The very distinction is largely

dependent on the length of time we consider ; and, besides, their relative importance is also different in different periods of time.

Q. 8. Write a short note on normal value. ( *B. A., 1923.* )

Q. What is market price? How is it distinguished from normal price ? ( *B. A., 1922.* )

The normal value of a commodity is that value which would be stable in the long run when the forces of demand and of supply have had full time to exert their influences. The normal value is, therefore, the long-period value under conditions of competition. In the short period, a change in demand will at once disturb equilibrium and supply will have no time to adjust itself to the change. But in the long period, supply will be exactly what can be disposed of and hence the price will have a *tendency* to be stable.

If normal price is defined as the long period equilibrium price, it is easy to see that the short period market price may vary from it though the range of variation will not be very great. The market price is the day-to-day price in the market, varying with every change in the conditions of demand and supply. This market price, however, will have a tendency to range round the long period normal price. If the market price remains for long below the normal price, production will be curtailed and in the reverse case production will increase. Hence, market price will always tend to come back to the level of the

Normal value—  
long run value

Market price  
may fluctuate

—But not very  
far away from  
the normal price

normal price, and if there is any deviation, it will not be of any far-reaching effect

The tendency for the day-to-day market price to reach the long period normal price is brought about also by the influence of speculation. The main effect of speculation is to bring about an equality between the market price and the long term price. If the market price at any moment is lower than what the speculator anticipates the long term price to be, the speculator buys large stocks, if the market price appears to be higher than the long term price, the speculator sells forward. If his anticipations come to be true, he gains and at the same time helps to bring about an equal distribution of stocks over the season. His purchases make the price rise and his sales make the price fall and in this way the market price comes to be equal or nearly equal to the long period normal price.

**B Q 9** Market values are governed by the relation of demand to stocks actually in the market, with more or less reference to future supplies and not without some influence of trade combination. Explain and illustrate (B A, 1928.)

By the market value of a commodity we mean the day-to-day price that comes to be determined as the result of short period conditions affecting demand and supply. In the short period, changes of demand can always take place but changes in supply are unlikely. Particularly, when supply conditions have remained stable for some time a sudden change in demand will bring about a maladjustment

between supply and demand which will not be immediately corrected. The market price, therefore, Actual stocks will depend upon the demand for the commodity with reference to the actual stocks in the market. In a fish market, for example, a change in demand on a particular day will leave the stocks unaltered, and hence price will depend upon the extent of the change in demand, i.e., upon the extent of the change in marginal utility.

The market price is also influenced by the anticipations about future supplies when the commodity has a seasonal Speculations supply, but is at the same time of a non-perishable nature. If the present market price is low on account of an excess stock and if the future supply is expected to fall short of demand, speculators will buy stocks and this will cause the present market price to rise. In the same way, if the present market price is high and if the future supply is expected to be large, speculators will begin to sell forward and this will at once lower down the market price.

The market price may also be affected by combinations among the sellers, and in rare cases even among the Combinations buyers. A group of sellers may 'corner' the supply in the market by buying up all available stock, and in this way earn monopoly profits for at least a temporary period. The market price is liable to fluctuations as the result of attempts to 'corner' supplies, or as the result of buyers combining together to 'squeeze' the sellers. Successful 'corners' or attempts to 'squeeze' sellers are, however, rare, and consequently, the effects of these are at best temporary.



✓ Q 10 On what grounds has it been held that speculation, if it is to perform a social service, must be confined to specialists ? Explain the utility of a market for dealing in futures to the businessmen ? ( *B Com 1910* )

Q Distinguish between legitimate and illegitimate speculation ( *B Com, 1912, 1930 1928, 1927* )

Q Discuss the nature of speculation showing that it is not gambling but it performs, within limits, a necessary economic function ( *B A, 1941, B Com, 1942* )

Q Discuss the economic functions of speculation. ( *B A 1923* )

The speculator is a person who tries to make a profit out of fluctuations in price. He buys a commodity when the present price is low, with a view to selling it in future when he expects the price to rise. And, he sells forward for future delivery when he finds that the present price is high but that there are indications of a low price in future.

A successful speculator is easily able to benefit society by lessening the range of price fluctuations. If he purchases a large quantity of a commodity at a low price with a view to selling dear later the increase in demand caused by his purchase would raise the price immediately. Later, when he would try to sell his stock the increase in supply caused by his sale would lower the price. Again when a speculator sells forward his sale would lower the current high price and later when he would make his purchases at the time of delivery his purchases will raise the price.

The operation of a speculator, therefore, raises the

price when it is low and lowers it when it is high. Speculation, when carried on by experts on scientific lines, would lead to a lessening of fluctuations and promotion of the smooth course of exchange and

Legitimate and consumption. Such speculation is certainly  
 Illegitimate *legitima*. But most of the persons going  
 speculation to the speculation market are inefficient

amateurs trying to get rich quickly through the play of chance. Such speculators themselves suffer, because their anticipations are rarely realised, and at the same time they make society suffer by increasing the range of price-fluctuations. The unskilled speculator will buy when the price is high and will have to sell when, contrary to his expectation, the price has fallen. His purchases at the time of the higher price and his sales at the time of the lower price will make the high price higher still and the low price lower still, thus bringing about an increase in the range of fluctuations in price. It is this inexpert speculation that we regard as *illegitima*. Henry Clay distinguishes four types of illegitimate speculation. These are: (a) speculation by the outsider, (b) dealing on insufficient capital, (c) producing artificial price-fluctuations, and (d) cases where no necessity for speculation exists.

So long as speculation is carried on by experts, having the power of anticipating correctly the future course of supplies, demand and prices, and having no intention of deliberate tampering with the market, speculators perform a necessary economic function; they bring the long-period supply in equilibrium with the long-period demand, bridge over periods of temporary scarcity or glut, keep prices steady, and thus benefit the consumers as well as the producers.

The businessmen are particularly benefited by the activities of the legitimate speculators. On the one side, the steadiness of the price of raw materials brought about by speculation in these makes their calculations correct and competitive position strong on the other, the steadiness of the price of the finished products enables them to carry on business with confidence. Besides, the existence of a speculation market provides "hedging" facilities of which advantage can be taken by all businessmen.

**Q 11** What is the economic justification of speculative dealings in stock exchange securities and land? (*B Com., 1934* )

Speculation is generally justifiable in the case of those commodities the supply of which is seasonal, i.e. irregularly distributed. As the supply is occasionally plentiful and at other times scarce the price will fluctuate, and speculation is necessary to steady the price and to smooth out the irregularities of supply. This is why we find economic justification for speculation in agricultural products.

Speculation would therefore seem to be unnecessary in the case of commodities the supply of which is fixed. But speculation in the stocks of joint stock companies and in land are very common. The stock exchange exists for facilitating transference of shares, but the main use to which it is put is to speculate in price fluctuations. The total supply of shares in the stock exchange is very nearly fixed.

and speculation here does not in any way 'average' the supply of shares throughout the year.

The case of land is similar—its supply is unaffected by a rise or a fall in its price, if, of course, we —and in the case of land ignore the possibility of developing new areas. Speculation in land, like speculation in shares, performs no service to society, and Government would be justified in taxing all speculative transactions of this nature.

Q. 12. Is it possible and desirable to check speculation by legislation ?

Legislation will not be a good device for checking speculation, for if it checks illegitimate speculation, it will also hinder legitimate speculation ; it is difficult to evolve legal measures that would check only the former without affecting the latter. It has been suggested that the most practical check on illegitimate speculation lies in "the diffusion of a feeling that such speculation is dishonourable." This can perhaps be done by spreading education and information more widely.

The Government of a country can partially eliminate the evil effects of illegitimate speculation by prescribing and enforcing strict rules for regulating activities in the speculation market. By making prompt payment and full publicity compulsory, the Government can at least check those backdoor activities which consist merely in gambling on the fluctuation of rates. Speculation in land and in the stock exchange can be easily stopped by any Government.

Q 13 Distinguish between prime and supplementary costs and examine the bearing of this distinction on the theory of value ( *B Com, 1935* )

Q Distinguish between prime cost and total cost Is the distinction valid for the long period ? ( *B A, 1940* )

Q Write a short note on prime and supplementary costs ( *B A 1928* )

Q Distinguish between prime cost and total cost Show that over the long period total cost is the important influence in fixing the amount of supply, over the shorter period prime cost is the important influence ( *B Com, 1942* )

If the cost schedule relating to the production of any commodity is carefully examined, it will be found that some items of the cost show variations with every change in the output, while other items are relatively steady i.e. do not change if there are small changes in the quantity produced In the first category would come the expenses incurred for buying raw materials employing labour by the piece paying commission for sale, providing depreciation for extra wear and tear of machines, etc., in the second category would come the payments made for interest on capital municipal taxes salaries of higher officials etc That part of the cost which varies directly with every change in the output is known as the special, direct or *prime* cost of production and the other part is known as the overhead or supplementary cost

The importance of the distinction between the prime cost and supplementary cost of production lies in the fact

that in the short period a seller may have often to sell a commodity at a price lower than the total cost. If there is a temporary slackening of the demand, no producer will wind up his business, but will try to sell his output at a price that will at least cover the prime cost. The prime cost is the minimum short period supply price.

The prime cost has to be kept in view in many other cases. A producer expanding output knows that the increase in cost will be mainly an increase in the *prime* cost, and as the supplementary cost is fixed, this partial increase in cost will make the average cost lower. A monopolist may increase his output and sell this extra amount at a price that will cover the prime cost only. In the case of joint products a separate prime cost has to be incurred for everyone of the products and this prime cost determines the minimum price in each case.

The distinction between prime cost and supplementary cost and hence between prime cost and total cost is quite valid in the long period, but the importance of the distinction disappears to a large extent. Even in the long period we can distinguish between prime cost and supplementary cost, though supplementary costs relatively to short periods may appear to be prime costs relatively to long periods. But the importance of the distinction is small, as in the long period the price must cover the total cost. The minimum long period supply price of a commodity is the marginal total cost,

= the sum of supplementary cost per unit and the prime cost at the margin

✓Q 14 Discuss the principle that regulates the value of joint products

Q Wool and mutton are jointly produced. Discuss the effects of changes in the supply of and demand for wool upon the price of mutton (B A., 1940 1934 1932, 1929)

Q Show briefly the relation between the prices of joint cost goods (B A., 1943)

Q There are cases when the exact cost of production of any single piece of work cannot be calculated. Illustrate this statement and explain the principle followed in fixing rates and prices in such cases (B Com., 1943)

There are many cases where two or more commodities are jointly produced in such a manner that the production of

any one of them necessarily entails the production of the other or the others

Examples are found in the joint production of wool and mutton or gas and coke, it is impossible to produce mutton without producing wool or to produce coke without producing gas

When two commodities are related to each other in this way, it becomes difficult to connect the supply conditions with the prices of the commodities. If the outputs of the two commodities are related to each other in an invariable

proportion, it is impossible to isolate their costs of production. If 10 units of mutton and 5 of wool are produced at a certain joint cost and if doubling of the expenses would produce just 20 units of mutton and 10 of wool, the

Meaning of joint supply  
When the proportion is not variable

relative proportions remain unchanged. In such cases the first principle that we can lay down is that the sum of the price of wool and the price of cotton must cover the total cost of production. The ratio between the price of wool and that of mutton can, however, be determined by comparing their marginal utilities. The prices of joint products are not, therefore, indeterminate even though it is impossible to isolate their costs. If we know the sum of the prices and also the ratio between the prices, (i. e. if we know  $x+y$  and  $x/y$ ) the prices become easily calculable. Of course, if after the joint products have been separated from one another, any special cost has to be incurred for making any of these suitable for the market, its price must cover in addition this extra cost.

The calculation of the prices of joint products becomes easy when the proportion between their outputs is variable,

|                                 |   |
|---------------------------------|---|
| When the proportion is variable | If at an expenditure of Rs. 15, 5 units of wool and 3 units of mutton can be produced and if 6 units of wool and 4 units of mutton require an expenditure of Rs. 16, the cost allocable to each can easily be calculated by solving two simultaneous equations ( $5x + 3y = 15$ and $6x + 4y = 16$ ). |
|---------------------------------|---|

In any case, a change in the supply or demand conditions of any of the joint products will have an effect upon the price of the other. An increase in the

|  |  |
|--|--|
| A change in the demand for or supply of one affects the price of the other | supply of one of the joint products will increase the supply of the other and thus push down the price of the latter. An |
|--|--|

|  |   |
|--|---|
|  | increase in the demand for one of the joint products will naturally tend to increase its supply, leading to an increase in the supply and a fall in the price of the other. |
|--|---|



This however, is only a general principle there may be special cases where special circumstances may have to be taken into consideration In the case of Exceptions

wool and mutton for example, an increase in the supply of or demand for mutton will have an inevitable effect on the price of wool But if it is possible to have wool without killing the sheep, wool and mutton become joint products with variable proportion and in such a case upto a certain limit a variation of the supply of and demand for wool may not cause any change in the supply or price of mutton But if there is a considerable change in the supply of or demand for wool the supply of mutton will be surely affected and hence the price of mutton will also change

Q 15 Gas and Coke are joint products A duty of 10 per cent is imposed on gas How will it affect the price of coke ? ( B A 1932 )

A duty of 10 per cent on gas will mean some reduction in the consumption of gas This will lead the producers of gas to restrict their output but that will automatically reduce the supply of coke in the market If there has been no change in the demand for coke the reduction in supply will make the demand greater than the supply and hence, the price of coke will increase

If however gas is only a subsidiary product secured together with the production of coke, a change in the consumption of gas will not materially affect production An increase or decrease in the demand for rice will naturally affect the extent of cultivation but a change in the demand for husk will not produce that effect even though rice and husk are joint products

Q. 16. Cost of production is coming more and more to mean joint cost; the price of a given product may bear only a remote relation to its individual cost of production. Illustrate. ( B. A., 1927. )

There are very few commodities which are produced all by themselves. Modern science is devising methods by which a use can be found for all that would otherwise have been regarded as waste products. In every branch of production we find that besides the production of the main article, a large number of subsidiary articles are also being produced. In an iron and steel factory, in a gas work, in a factory manufacturing drugs and chemicals, we find extensive instances of such joint production. The same factory may be turning out iron and steel and different varieties of iron goods and steel goods. The cost is jointly incurred and the price of an individual product necessarily bears a remote relation to its individual cost of production.

It should, however, be remembered that all cases of production of a number of commodities in the same factory are not cases of joint production. By 'joint products' in the true sense of the term, we mean products related to one another in such a way that the production of any one necessarily entails the production of the other or the others. If a particular chemical factory is producing sulphuric acid and sodium bicarbonate, the cost to a large extent is *common*, because the same management expenses are being incurred for both, but is not really *joint*, because one of these can be produced without producing the other.

Even in these cases however the price of each will bear only a remote relation to its individual cost of production. The remoteness of the relation arises not because it is impossible to determine the individual cost of production but because it is not often worth while attempting to determine it. The producer incurs a huge aggregate cost for producing all the articles. The price of each is so fixed as to cover the prime cost incurred for its production and also to cover a part of the common supplementary costs. The part of the supplementary costs that each will cover will be fixed so as to suit the convenience of the producer and consequently it will bear only a remote relation to the individual cost of production.

Q 17 Show how prices of different commodities may be related to one another

Q State briefly the relation (a) between prices of competing goods and (b) between the prices of complementary goods (B A 1943)

The prices of different commodities may be related to one another when they are *joint products*. Any change in the supply or demand conditions of one of the joint products is bound to have some repercussion on the price of the other or others.

Joint-cost

Similar inter relation between prices is found also in the case of *joint demand* for two or more commodities from the same consumer. Joint demand exists in the case of *complementary commodities* like bread and butter motor cars and petrol etc. Any increase in the demand for bread will increase the

Joint demand

demand for butter, and an increase in the demand for cars will cause a rise in the demand for petrol.

When commodities are related to one another by way of *composite supply*, i.e. when they are *substitutes* for one another, their prices will move together. If *Composite supply* tea becomes dearer and coffee cheaper, the demand for tea would decline and that for coffee increase, leading ultimately to some fall in the price of tea, and some rise in the price of coffee. There cannot, in the long run, be much difference between the prices of two articles which are substitutes for one another, for, if such difference exists, people will go in for the cheaper substitute, causing a rise in its price simultaneously with a fall in the price of the dearer article.

And lastly, when a number of articles are all made by using a common factor, i.e. when there is a *composite demand* for the factor, their prices will be inter-related. All articles made of iron will increase in price when iron becomes scarce. The use of a large quantity of iron for armaments in the war has increased the price of every iron or steel goods, from locomotive engines to beams and rails, from steam rollers to safety pins.

We find, therefore, innumerable examples of inter-relation between prices. There is practically no commodity which is not related to some other commodity, either through joint supply or joint demand or composite supply or composite demand. It will be difficult, therefore, to find a commodity the price of which is determined by the conditions affecting its own demand and supply alone.

Q 17 Indicate and compare the principles which determine exchange value under (a) Competition and (b) monopoly ( *B Com, 1941, 1933 1932 B A, 1933, 1926* )

Q Monopoly price is influenced by cost of production but in a different way from competitive price ( *B A, 1929* )

Q What are the factors that a monopolist takes into account in fixing the price of his product? ( *B Com, 1941 1942 1938* )

Q There are potent restrictions on the price fixing power of the monopolist Elucidate ( *B A, 1941* )

Q On what principle does a monopolist fix the price of reproducible goods? Show how monopoly price is affected by elasticity of demand, substitutes, potential competition, regard for future demand and risk of legal interference ( *B A 1944* )

By monopoly we mean complete control over the entire supply of a commodity exercised by a single individual or a group of persons Absolute monopoly is however, rare and we are therefore, justified in describing monopoly as a substantial control over the supply of a commodity The test of monopoly is the absence of competition or to be more correct the absence of the effects of competition Under competition value tends to be equal to the marginal cost of production For short periods value may go above or below this marginal cost but in the long run value and marginal cost must coincide The producer under competition, cannot choose between this price and

Meaning of  
monopoly

that; he has to accept the market valuation of his commodity at a level equal to the marginal cost of production.

The monopolist is under no such limitation. He can control the supply, and because of this he can regulate the price of the commodity. He will naturally try to sell his commodities at a price that will make his monopoly profit the highest possible. He will so adjust his output as to be able to demand that price which will give him the maximum monopoly net revenue.

In the main, he has to take into consideration two factors—the elasticity of demand for the monopolised commodity and the cost per unit. If the demand is elastic, the monopolist will be able to sell a large output at a low price and thus make a big profit. If, however, the demand is inelastic, a lowering of the price will not increase the demand much, and consequently it will be profitable for the monopolist to sell as much as he can at a high price.

The cost of production naturally sets the lower limit. If an increase in production means a lowering of the cost, the monopolist will expand output; if, however, the cost gradually increases, the monopolist will try to restrict output. When the demand for the commodity is elastic and the cost of production gradually decreases with an increase in the output, the monopolist will produce a large output, reap the advantage of a low cost, sell at a fairly low price a very large quantity and make a large total profit. On the other hand, if the demand is inelastic and the returns diminishing, the monopolist will

curtail production and sell a moderate quantity at a high price

Cost of production thus influences monopoly price in a different way from competitive price. In a competitive system the cost of production not only sets the lower limit, but in the hand of the marginal producer it becomes the effective determinant of value. The marginal cost and the marginal demand price have to coincide and this coincidence brings equilibrium into existence. In the case of monopoly what is important is not the cost of production

The difference between demand price and cost itself but the difference between the aggregate demand price and the aggregate cost of production. The demand price and the cost do not and need not coincide—and the importance of cost lies in its difference from the price offered by the buyers for the quantity put on the market.

The monopolist thus wants to secure the *maximum benefit* out of his position as a monopolist and has to give due consideration to the behaviour of the demand and to the behaviour of the cost. But there are many instances when he has to satisfy himself with what Marshall calls a *Compromise benefit*. The monopolist has

Compromise benefit always to be alert lest he loses his position and as an insurance against this risk he often charges a price lower than that which would give him the maximum benefit. He has to remember that

Potent restrictions on the powers of the monopolist *potential competitors* are always trying to enter the field—either from his own neighbourhood or from a foreign country. *Substitutes* may be put into the market. Consumers may become harassed by high

prices and may induce the *Government* to take *action* against the monopolist. And consumers may even form a counter-combination to beat the monopolist in his own game. In order to forestall all these, the monopolist has often to charge a low price and these should, therefore, be taken as additional factors that affect the determination of monopoly price.

Q. On what principle does a monopolist fix the price of non-reproducible goods ( *B. A., 1944.* )

The cost of production is a material factor in price-determination only when there is a continuing possibility of further production. When a particular commodity cannot be reproduced, its cost of production ceases to be a material factor. The seller has in such a case to sell at the price which the buyers are willing to pay, and in the case of a limited supply, naturally the highest bid from the customers' side determines the price. This 'highest bid' may be lower than the cost of production and it may also be many times higher. The supply factors have no influence except in that the seller is willing to sell, and the price of such a commodity will depend on the strength of the demand for it.

Q. 18. Discuss the merits and defects of the system of monopoly in industry. ( *B. Com., 1929.* )

Q. "There are important industries in which monopoly is a technical necessity." Explain this proposition.

( *B. Com., 1939.* )

Monopolies generally are of two types—those which are the outcome of technical considerations, *i. e.* those in which monopoly leads to economy and efficiency, and those which are the outcome of the profit-motive. In the first category would

Two types of monopoly



come all cases where monopoly is socially desirable e.g. railways telephone systems, tramways, water supply, electric supply, etc. There are some services which are essentially of such a nature that they can be efficiently worked only by a monopoly. A single telephone system within a region is for example much more convenient than a number of competing systems.

Besides there are some industries like railways in which a very huge quantity of fixed capital and initial expenditure is necessary. It is impossible for two competing firms to make this initial outlay separately and even if it is possible, it is not profitable to do so. Hence in such industries monopoly is the only course possible.

Competition in the case of railways or telephones is "*difficult wasteful and futile*" because it is only possible by duplicating an expensive organisation for a limited market, *wasteful* because the services can be supplied at their lowest cost only if the whole market is served by a single plant or organisation, *futiles* because the superiority of the stronger competitor is increased by competition so that competition must result in the establishment of monopoly by the ruin or retirement of the weaker competitors. \*

The danger of monopoly is however that it may come into existence even where it is not socially necessary. Any combination among producers is likely to be successful in bringing in monopoly, and if some rivals remain outside the combine

Causes where competition is difficult wasteful and futile

Dangers of monopoly

tion, the latter can break them up by adopting devices of various sorts. Combination and monopoly not unoften lead to high prices and profiteering, price discrimination, unfair devices like preferential railway rates or deferred rebates, and in the final analysis consumers' surplus is reduced. It has, therefore, become an accepted policy of many governments to adopt legislative measures for restraining monopolies.

Q. 19. Indicate the different methods of Government intervention for the purpose of regulating monopolies. (*B. Com., 1939.*)

Q. Monopolies should be very carefully watched and controlled by the State. Why and how? (*B. A., 1930.*)

There are some industries in which in the interests of economy and efficiency monopolies are desirable. But when a monopoly has once been allowed to grow up, it may injure the sum total of the consumers' satisfaction by profiteering or by price discrimination. It has also been pointed out by Pigou and his followers that the output of commodities under monopoly is usually smaller than what it would be under a free and perfect competition.

In the interests of social welfare, therefore, it is desirable to regulate and restrain monopolies. The legal measures adopted by the State may be of different types.

The State may try to maintain competition and prevent monopolies from coming into existence. The classic example of such legislation is the Sherman Anti-trust Act of 1890 of the U. S. A. It has, however, been the experience of law-makers

that it is difficult to devise adequate laws for preventing monopolies from being formed

The State may try to regulate monopolies by the comparatively mild method of giving publicity to the affairs of monopoly business. Publicity is sometimes an effective check upon undesirable action and particularly in a country where the public opinion is alert and watchful such publicity may achieve much.

✓Publicity

The most important methods of controlling monopolies are, however, those intended to regulate the details of monopoly business, *i.e.* to control prices and profits, to tax monopoly profits at high rates, to prevent rate-cutting rebates and other competition eliminating practices. Almost every Government has done something in the direction of regulating the prices charged and the profits obtained by the monopolists.

Control of prices and profits

The best solution would, of course, be that the State should acquire all monopolies and work them in the interests of the public. Some monopolies are 'public' in their very nature, and it is only proper that they should be worked by the State or by a company under obligation to the State. It is coming now a days to be generally admitted that railways, electric supply, postal telegraph or telephone services should be in the hands of the State and should be worked either on a no-profit basis or in such manner that the profit earned may be spent for the benefit of the people. Schemes for 'socialisation' or 'nationalisation' are part of the socialistic programme and it is no use denying that we are all socialists now."

Nationalisation of monopolies

✓ Q 20. Critically examine the labour theory of value.  
( B. Com., 1939, 1936. )

Q. Examine briefly the principal theories of value.  
( B. Com., 1927. )

At the present day we explain the emergence of value by relating demand to supply, *i.e.*, by examining the forces that make marginal utility and marginal cost of production equal to one another. Earlier writers on economics had, however, tried to localise their explanations of value by concentrating attention upon one factor among the multitude of the causes of value. Some found the explanation of value in the well-known *labour theory*, some in *cost of production* and others in *marginal utility* alone. All of them agreed in regarding market value as being determined by demand and supply ; they differed in their attitude towards *normal value*.

The *labour theory* was first put forward by Adam Smith, and later emphasized in different forms by Ricardo and Karl Marx. All of them ignored the effect of utility on value and Adam Smith found the explanation of the very low value of some very useful commodities in their low labour-value. Ricardo regarded labour as the "foundation of all values" and "the relative quantity of labour as almost exclusively determining the relative value of commodities". Marx pointed out that "the value of a commodity is determined by the quantity of labour expended during its production".

It is, however, difficult to accept this theory 'as an explanation of existing values'; the greatest difficulty arises from the fact that no definite meaning can be attached to the expression "quantity of labour." The term 'Labour' has no single,

Labour theory  
of value

Difficulty of  
measuring  
labour cost

definite well understood meaning. There are different kinds of labour some requiring physical skill and some intelligence of the brain some requiring no training at all and some calling for long strenuous and costly apprenticeship. There is no common measure by which labour of different sorts can be compared and evaluated. If the time spent is taken as a standard injustice is done towards intensive labour and there is no method for measuring the pain or the sacrifice involved in working for the production of a commodity. Ultimately we have to depend upon the market value of labour as the measure of labour but when we do so the labour theory loses meaning as an explanation of value.

*The Cost of Production theory* differs from the labour theory in allowing for elements other than labour e.g. cost of materials, interest charges and the earnings of management. The price according to this theory will in the long run be equal to the cost of production and if cost varies from producer to producer the price would equal the cost of production under the most disadvantageous existing circumstances.

This theory also suffers from difficulties. It ignores utility entirely and consequently ignores the possibility that labour may be misdirected. *Secondly* this theory does not explain why or how the value of a commodity changes *after* it has been made. *Thirdly* this theory fails to explain the special cases of value e.g. when scarcity makes the value much higher than the cost or when dumping makes the value lower than the cost. And *lastly* there are cases where cost of production of any single commodity or service cannot be

calculated ; this is particularly true of joint products and also in the case of commodities of which the prime cost is a small part of the total cost.

*The Marginal Utility theory* of value errs on the other extreme. It attaches importance only to the subjective valuation of a commodity, i. e. to the marginal utility that it would be able to yield to the consumers in the market, and it ignores altogether the objective conditions affecting the supply of the articles.

To-day we recognise that it is not possible to find an explanation of value in any single factor and that value depends on the whole set of conditions affecting demand and supply. The whole set of conditions no doubt includes cost of production and utility, and it remains true that these two are the fundamental factors affecting value. But in any case, due importance has to be given to the governing factors and to their inter-dependence. The theories referred to above erred in attempting to isolate factors that are not really capable of isolation.

Q. Examine the contention that in our present economic order based on competition, market values correspond roughly with social values and are an adequate indicator which we have only to follow to secure the greatest possible amount of satisfaction from efforts and sacrifices of production. [ *B. Com., 1942.* ]

It was the general belief of classical economists that market values indicated something ethically right. Free competition was regarded by them as the best of all things, and consequently any resultant of the forces of free competition must necessarily be good. Competition price was thus

regarded as an indicator of social values, and when an equilibrium price would be reached, it was assumed that the buyers and sellers taken together would attain the maximum possible amount of satisfaction

But, now a days, apart from the fact that a truly competitive price is a rarity, economists have come to recognise the unsoundness of the assumption that price is an indicator of social values and that what is good for the sellers is also good for the buyers. All that can be said is that price is an index of social valuation and not of values, and that this valuation is necessarily dependent upon the structure of society, its level of development, its habits, tastes and temperament, its economic institutions and its scheme of distribution of wealth. Change any of these, and society's valuation of commodities will also change. Prices, therefore are the products of the institutional foreground of human society and are nothing more

Besides, equilibrium in itself, is nothing sacred. It represents a balancing of forces, a level at which demand and supply equate. There is nothing specially worthy in this balancing just as there is no ethical value in the stable position obtained by a kite flying in the sky. The fact that an equilibrium rate has been reached does not mean that the most desirable situation has been reached. A deliberate lowering of the price of a commodity below what would otherwise have been the equilibrium price may cause more good than injury. The equilibrium price is not necessarily the price that is conducive to the maximum amount of social welfare, nor is the equilibrium level of wages, the most desirable level.

---

# CHAPTER VI

## Distribution

Q. 1. "The National Dividend is at once the aggregate net product of and the sole source of payment for all agents of production within a country". What is the national dividend and on what principles is it distributed among the factors of production ? ( *B. Com.*, 1940, 1927 ; *B. A.*, 1935.)

The factors of production of a country working together are able to produce every year a net aggregate of wealth which is available for distribution among those who have contributed to its production. This net annual income is obtained by subtracting from the gross annual income the charges on account of the depreciation of fixed capital goods and of the maintenance of these capital goods in an intact form. We give the name National Dividend to the divisible fund of wealth and, naturally, it is this that is exhausted by being distributed as rent, interest, wages and profits.

The broad principle which determines the manner of distribution of this national dividend among the factors of production is based on the law of substitution. Factors of production will be used so long as it is profitable, or, at least, not unprofitable to do so. The employer will employ every factor so long as the marginal return from the factors does not go below what has to be paid for securing its

Meaning of  
national dividend

Distribution  
based on  
substitution



supply In the long run, under equilibrium conditions, the amount paid to every factor will equal its marginal productivity. If any factor yields a higher product than the equivalent of its reward, more of that factor will be used, and consequently the marginal product and the reward of the factors would come to be equal.

This theory we call by the name of the marginal productivity theory, and it is this theory that underlies all explanation of the problem of distribution of the national dividend among the landowners, labourers, capitalists and entrepreneurs.

Q 2 In every particular variety of price analysis whether it be rent, interest, wages or commodity prices, there lie back of demand and supply, influences peculiar to the particular variety of market and price." Specify these influences in each of the above cases (B A, 1943)

The general laws of demand and supply operate through the whole field of price determination, but there are different types of markets and demand conditions and the conclusion in every particular case has to be modified in the light of the special factors that may be operative.

In the case of commodity prices we have to distinguish between competitive conditions monopoly and imperfect competition. Conclusions true about perfect competition are not necessarily true about monopoly and similarly conclusions true about the short period are not always valid in the long run. There are again different degrees of elasticity of demand and different types of cost curves, each influencing the price in its own way. The existence of

substitutes, the presence of speculation, the complications of joint demand and joint supply all play their part in giving shape to the resultant price.

In the case of rent, the special factors to be taken into consideration are many ; the inelasticity of the total supply of land, the possibility of using a land for alternative purposes, the lack of uniformity, the influence of situation, the operation of the law of diminishing returns and the effect on the demand for land produced by changes in population, or new inventions or improvements in the means of communication. Private property in land is also an important factor.

In the case of interest, the demand will depend mainly on the marginal productivity of capital, which again depends on the productivity of other factors of production and on new inventions and innovations. The market for capital is governed by people's incomes, their attitude towards spending and saving and their attitude towards lending and holding liquid money in their own hands.

In the case of wages, demand no doubt depends on marginal productivity, or more strictly on the discounted marginal net product. There are peculiar influences on the supply side. As in the case of land, the total supply of labour is relatively inelastic, and a further complication is added by the fact that there are non-competing groups. The poverty of the labourers, the perishability of their service, their immobility render the market for labour imperfect from the labourers' side. The slow but effective influences of standard of life, education and training and the quick and direct effects of trade unionism are also special factors to be taken into account.

## Rent

Q 1 Explain how the economic rent of land is determined ( *B Com*, 1941, 1936 1931, 1929, *B A*, 1945 1939, 1935 1929, 1928 1927, 1925 )

Q Show how (a) the quantity of lands, (b) the margin of cultivation and (c) the price of the produce affect economic rent ( *B A*, 1942 )-

Rent is the name given to the return secured by the landowner for the services performed by the land supplied by him. As a factor of production, land shows certain peculiarities, and on account of these, the problem of rent takes a complexion different from that of the problems of other kinds of rewards. Land is characterised by inflexibility of supply, by lack of uniformity of quality, by the great influence exercised by situation and by the fact of the marked operation of the law of diminishing returns. Each of these characteristics has an important bearing on the emergence of rent.

The first scientific explanation of the origin and determination of rent was given by Ricardo in the early years of the last century and even to-day we take his theory as the explanation of the basic nature of rent.

A country in which large areas of land are lying uncultivated would naturally attract settlers, and, according to Ricardo, the first settlers will choose for themselves the most fertile lands. Suppose the first area so chosen gives a return of 100 mds of wheat at an expenditure of Rs 400, the average cost being Rs 4 per maund. If now population

The Ricardian theory

grows in such a community, demand for more food material will arise and this will necessitate either intensive and extensive cultivation, or more thorough cultivation of the area already brought under cultivation or *extensive cultivation* or cultivation of new plots of land in addition to those already cultivated. Intensive cultivation will not, however, be possible after a few stages on account of the *operation of the law of diminishing returns* and, so, extensive cultivation will become necessary.

But when the second grade land is brought into cultivation, the cost of production on it will be higher than on the first grade land. If Rs. 400 spent on the first grade land secures 100 maunds of output, the same expenditure will probably secure only 80 maunds of output at a cost of Rs. 5 per maund from the second grade land. The same crop, wheat, therefore, comes to be produced at a cost of Rs. 4 per maund on one plot and of Rs. 5 per maund on the other.

Naturally, the price of wheat under these circumstances will have to be at least Rs. 5 per maund; otherwise the second grade land will not be cultivated at all. And if the price is Rs. 5, the owner of the first grade land will also be able to get the advantage of this price. As his cost of production is only Rs. 4 per maund he will be able to earn a surplus of Rs. 1 for every maund raised, i. e. a total surplus of Rs. 100. This surplus, it is important to note, arises not because of any superior skill of the owner of the first grade land, but because of the natural superiority of this plot of land over the second grade land or the 'land on the margin of cultivation.'

To this surplus we give the name rent and we can define this rent as the differential surplus enjoyed by a superior land on account of its superiority over the marginal land. Rent is thus the measure of the superiority of a particular plot of land over the land on the margin of cultivation. This rent arises because the operation of the law of diminishing returns makes intensive cultivation unprofitable and because the scarcity of good land necessitates the taking into cultivation of inferior lands. Once we have the cultivation of two different grades of land together, the price of the crop will be settled by the cost on the worse of the two plots and the better of the two will earn a surplus or rent. As cultivation extends to worse and still worse lands the margin recedes and the differential superiority of better lands increases causing an increase in the rent earned.

The differential superiority of one land over another may be due to a number of factors, *e.g.* fertility, situation, level, distance from market towns, climatic conditions, etc. Whatever may be the cause of difference, the existence of it will result in a rent for the super-marginal lands.

Q 2 Discuss the relation between rent and the price of agricultural product. Does rent enter into price? 'Rent is not an element in the cost of production' Elucidate (B Com., 1939, 1936 1932 1927, B A., 1936 1935, 1921)

According to the generally accepted theory of rent (which is nothing but a modified version of Ricardo), the

land on the margin of cultivation earns no surplus and, therefore, pays no rent. The cost of production on this marginal land determines the price of the product and the rent of the other plots of land is the difference between this price and their individual costs of production. Rent, therefore, is the difference between the marginal cost and the cost on a particular plot, and consequently it enters into neither of these. It is not a part of the cost on the marginal land, because the marginal land pays no rent at all; and it is not a part of the cost on the super-marginal lands because by definition and by nature it is the surplus over and above the cost of production.

Rent—a difference —and hence not a part of cost

Rent, therefore, is not a part of the cost of production in any case and hence it is not an element entering into the determination of price. In this sense it is said that rent does not enter into price. The relation between rent and price is thus the reverse of what it apparently seems to be: high rent is not the cause of high price but the result of high price. This is true not only of agricultural rent but also of rent of other sorts. ( See next question. )

Q. 3. A shopkeeper in a fashionable street says that he charges high prices for his goods because he has to pay high rent for his premises. Is this contention valid ? ( B. A., 1940. )

Price under competition would always be determined by the cost of production incurred by the marginal firm, and as this firm will not be able to earn any surplus, the

price will be determined independently of rent. Even if therefore we find that a shopkeeper in a fashionable street is charging high prices and is also paying high rent, we should not make the mistake of thinking that the prices are high because high rent is being paid. The relation ship is the other way round: a high rent can be paid because the shopkeeper can find purchasers who will pay high prices. There are people who would rather pay a high price in a fashionable shop than purchase their requirements at low prices in unfashionable surroundings.

The satisfaction of the snobbish love of distinction is one of the utilities purveyed in these shops and people pay high prices because their vanity is flattered by obsequious demeanour and a suggestion of superior company. Rent therefore is high in fashionable quarters *because of the fact that there are persons who will pay prices high enough to enable the sellers to pay such high rents*.

Q 4 Discuss the validity of the statement 'Rent is not an element in the cost of production from (a) the individual and b) the social point of view' (*B Com. 1936*)

Q Consider the social implication of the theory of rent. (*B Com., 1915-1941*)

When we say that rent is not an element in the cost of production we are speaking from the social point of view. From the standpoint of the individual rent is a money payment that has to be made in course of the process of production and it is therefore as much a cost of production as any other monetary outlay is. If by nature rent is determined by forces independent of the cost of production the individual cultivator does not realise

it. It is from the social standpoint that it is important to note that rent is not a part of the cost of production.

An item of cost of production from the social standpoint means some sacrifice or effort for somebody in the community. Wages represent the labourers' efforts, interest the capitalists' forbearance, Social cost implies sacrifice

But rent does not represent any sacrifice because it does not ordinarily arise from anybody's effort. If wages are made to disappear, labourers will not be available; if interest is made illegal, lendings will be considerably curtailed; but if rent is prohibited, the supply of land will not be affected. The relation between land and its reward is, therefore, fundamentally different from the relation between labour and its reward or between capital and its reward. It is this difference that is reflected by the 'differential' nature of rent, i. e. by the fact that rent is not a part of the cost of production of a commodity from the social standpoint.

This special nature of rent has led socialists to describe it as an 'unearned income'. In so far as land is a free gift of nature and rent accrues only because of the good fortune of possessing superior plots, the special nature of this income is apparent. The social importance of the distinction between rent and other types of income lies in the fact that because of its differential nature, it is a particularly suitable object for taxation.

Q. 5. Would there be any economic rent if all lands were equally fertile, or if there was no tendency towards diminishing returns? (*B. Com.*, 1927; *B. A.*, 1915, 1929, 1925,)



If all lands are equally fertile there will not be any difference between one plot of land and another. The result will be that cultivation will be pushed precisely to the same extent upon every plot of land and stopped at the same intensive margin everywhere. At this intensive margin the cost of production will be the same for every plot but this marginal cost will be higher than the costs of the earlier instalments on every plot. The marginal cost will determine price and on every plot there will be some instalments of output produced at a lower cost than the marginal cost. A surplus will thus be secured and this surplus will be the same for every plot of land—being measured by the difference between the cost at the intensive margin and the cost at the pre marginal stage. Rent will thus exist even if all lands were equally fertile. This rent will further be a measure of a difference but the difference it will measure will not be one between the productivity of one plot of land and that of another but between the productivity of the earlier doses of capital and labour and of the marginal dose.

Equal rent in  
cases of equal  
fertility

If however even the law of diminishing returns does not apply rent disappears. Extensive cultivation and increasing cost are the results of the operation of this law. If the law does not apply cultivation will not have to be extensive and cost per unit will not increase, and hence there will be no differential surplus for any part of the output.

Besides plots of land that are equally fertile may be situated at different distances from the market which they serve consequently some differential advantage arises in favour of those lands which are conveniently situated. The

prices of agricultural products must cover the transport costs of inconveniently situated plots, if these have at all to be cultivated, and hence, plots of land from which transport costs are low will earn a surplus. Moreover, in a country where land is scarce and the demand for land very strong, scarcity-rent can arise even if all lands are equally fertile.

Q. 6. 'Rent is paid for the original and indestructible powers of the soil.' Discuss. (*B. A., 1928.*)

In discussing the nature of rent Ricardo had said that the differential surplus of the super-marginal land would be due to the 'original and indestructible' powers of the soil. This statement of Ricardo was *Inexact wording* of the soil. This statement of Ricardo was *inexactly worded*. The powers of the soil are neither wholly original nor indestructible. The fertility of the soil depends mainly on its chemical composition and this composition naturally changes if manures are applied, or if a flood takes place. The powers of the soil are not indestructible either. Ricardo was familiar with the operation of the law of diminishing returns and it was, therefore, surprising that he regarded the productive power of the soil as 'indestructible.'

Perhaps all that Ricardo wanted to convey was that there would always remain something of the original power of the soil in spite of changes and that the original differences between one plot of land and another would persist in spite of efforts to reduce them. If this interpretation is accepted we may conclude with Marshall that Ricardo's main defect was that his theory was 'inexactly worded'.

The modern student of economics would, however, point

out that rent would arise not only on account of differences in fertility or productivity, but also on Differences other account of differences arising from any than those in the powers of the soil other cause, e.g. situation, transport cost, etc. Rent arises from any scarcity and any difference in quality and it is not, therefore enough for us merely to look to differences in the 'power of the soil'

Q 7 Trace the effects of improvement in agriculture on the interest of the landlord (*B Com, 1933*)

Q Examine the effects on rent of (a) agricultural improvements, (b) improvement of the means of communications and (c) growth of population (*B A, 1937*)

Q Consider the effect of an increase in population upon rent (*B Com, 1943*)

Anything that tends to increase the difference between the super marginal lands and the marginal land increases rent and any cause reducing the differences would decrease rent. If improved methods of agriculture are applicable only to the worst lands, these will become better the margin will rise and hence rent of the other lands will fall. If improvements are applied only to the best lands, these will become better still and hence their rent will rise. If improvements are applicable to all lands equally, at first differences will remain unaffected. But these improvements may enable society to get its requirements from a smaller number of plots than formerly. This will make it unnecessary to cultivate the lands formerly on the margin, the margin will, therefore, rise and the rent of super marginal lands will fall.

The effect of improvements in the means of communication will be different according as such improvements facilitate importation of crops or exportation of crops. If importation is facilitated, the supply of agricultural products will increase, their price will fall and some lands on the lowest rungs will have to go out of production. This will raise the margin and hence rent will fall. If, on the other hand, improvements in the means of communication bring about a marked increase in the exportation of crops, production will increase, new lands will be taken up for cultivation, the margin will recede, and hence rent of all lands will increase.

An increase in the population will always have one effect, namely to increase rent. A larger population will mean a larger demand for foodstuff and other agricultural products, and this will push down both the intensive and extensive margins of cultivation, causing an increase of rent.

Q. 8. Discuss the nature of building rents. (*B. A., 1927.*)

Building rents present a case analogous to that of agricultural rent. Agricultural rents arise because of the operation of the law of diminishing returns and lack of uniformity in quality. In the case of building sites, too, the same two characteristics are visible—the continuous application of capital and labour upon the same building site, *e. g.* the increase in the height of a building, will inevitably lead to diminishing return, and it is also a patent fact that all sites are not equally suitable for building purposes.

The operation of the law of diminishing returns in the case of the superior sites will necessitate the use of the inferior sites. The higher rent of the superior sites will, therefore, reflect the differential superiority of these sites over the inferior ones.

The inferior plots will also be able to yield rents—mainly because of two reasons. Building sites are generally scarce in relation to demand and this will create a scarcity rent for all sites. And, besides on every land, good or bad, there has been some investment of capital and some return must be had from this. Strictly speaking we should call this return from investment by the name of *quasi rent*, but ordinary language would not distinguish between such returns and rent proper.

### Interest

Q 1 Distinguish between gross interest and net interest. Account for the high rate of interest usually charged by the Indian money lender to the ryot. 'The rate of interest is 2% in the Calcutta money market, but a cultivator borrows at 18%'. Explain this difference. (B A 1935, 1927, 1921)

By interest we mean the remuneration that the capitalist gets for the service rendered by the capital lent by him. Interest—a price. It is thus a price for a service rendered, a price that is necessary to induce the lender to wait or to forgo his present opportunity of spending his money, a price necessary to overcome his unwilling

ness to lend. This price is determined by the equilibrium between the marginal return from capital and the marginal unwillingness to lend.

In actual practice what goes by the name of interest often includes elements other than the net price for the pure service of capital. When the lender finds it risky to lend, he usually charges something extra as the price for the risk undertaken. Sometimes the lender has to incur extra expenditure for recovering the interest and the principal and naturally he would try to compensate himself by adding something to the interest charged. If, again, loanable funds are scarce and the lender is in the position of a monopolist, he can charge a very high amount and this, and though usually taken as interest, it is nothing but a monopoly gain.

We may, therefore, apply the term *net interest* to the price paid for the pure service of capital and the term *gross interest* to the total charge paid by the borrower to the lender—this total including net interest, a price for risks, a compensation for extra expenses incurred and, in some cases, a monopoly gain. When we find that the money-lender in the village charges high rates to the cultivator, we have to note that his charges represent *gross interest* including not only pure or net interest but also all the other elements mentioned above. A very large part of the high rate charged by the money-lender is due to his monopoly position, and another large part is due to the risk undergone by him. It is because of all this that a businessman whose credit is beyond doubt can borrow from the money market in Calcutta at 3%, while the cultivator has to consider himself lucky when he can borrow at even 18%.

Q 2 Examine the causes that determine the rate of interest at any particular time (*B Com., 1937 B A 1927*)

Q Interest is the measure of marginal forbearance or marginal productivity Explain and comment (*B A 1935 1933*)

Q Show how the law of supply and demand determines interest in the same way as the value of a commodity (*B A 1941*)

Q 'Interest is the value of the use of capital and like any other value depends on the relation of supply to demand Elucidate the proposition (*B Com., 1945*)

Q Show how the competition of lenders and borrowers in the money market tends to make the rate of interest coincide with the marginal productivity of capital (*B Com. 1935*)

We define interest as the price paid by the borrower to the lender for the use of capital. The borrower can pay it because the use of capital means an increase in his outturn, and if the value of this increased outturn is not less than the price paid for securing the capital required for producing it the borrower can go on borrowing. The borrower has to pay interest because the lender has to postpone his present enjoyment and naturally he would be unwilling to do so unless a price were paid for overcoming this unwillingness. As interest is the value of the use of capital, it depends like any other value on the relation of supply to demand.

On the side of demand therefore, interest is the measure of the use-value of capital to the producer. He has to

calculate the increase in the output secured as the result of an increased use of capital, and to see whether this increase in output or 'marginal product' is greater or smaller than the rate of interest. If the interest rate is smaller than the marginal product of capital, the producer finds it profitable to borrow and to use more capital. But this very act will set the law of diminishing returns in operation and the marginal product of capital will decline. The producer will stop borrowing when the marginal product of capital and the interest are equal, because any further application of capital beyond this stage will make the marginal return from a dose of capital smaller than the price paid to secure it.

In equilibrium, therefore, the rate of interest and the marginal product of capital will coincide. On the side of supply, we find, there are many savers and lenders, actual or potential. Some may be willing to save at a very low rate of interest, or even when the rate of interest is zero. There are again others who will save and lend only when the interest rate is fairly high. We can arrange all lenders in order of their unwillingness to lend, putting first those whose unwillingness to lend is negligible and bringing in gradually those with higher degrees of unwillingness to lend. This unwillingness comes from "time-preference" or the preference for present consumption of resources held.

If, in equilibrium, a particular amount of capital is necessary, the rate of interest must be high enough to induce the least willing lender to lend. If three lenders



can lend Rs 100 - each, and if to overcome their unwillingness rates of 2% % and  $\frac{1}{2}$ % have to be paid, a total loan of Rs 300/- cannot be secured unless the rate offered is as high as 4%—the rate necessary to induce the marginal lender to lend, i.e. to overcome the marginal unwillingness of the lenders to lend

Interest thus is on the one side a measure of marginal productivity and, on the other, of marginal forbearance or marginal sacrifice of waiting. The play of demand and supply thus would establish an equilibrium rate of interest just in the same way as it would establish an equilibrium price for any commodity. The equilibrium rate of interest makes the amount of loanable funds demanded equal to the amount supplied and the marginal efficiency of capital equal to the marginal forbearance of the lenders.

## Wages

Q 1 Distinguish between nominal wages and real wages (B Com 1928, B A, 1920)

We mean by wages the net remuneration earned by a labourer in return of the service performed by him. Generally the whole or at least the major part of the wages is paid in money, and to this money payment that the labourer receives we give the name *nominal* or *money wages*. But the net aggregate advantage secured by the labourer out of his employment may include elements other than money. A particular labourer may receive free quarters, free medical aid etc. his cost of training may be low and the period of apprenticeship short, his employ-

ment may be congenial and stable and his prospects bright. Even if the money wages in such an employment is low, the labourer will accept it in view of the other advantages available. To this net sum total of all advantages yielded by a particular employment we give the name of *real wages*.

The real wages, it may further be noted, will vary with every change in the price level or the purchasing power of money. If the money wages remain constant, but the price level falls, real wages will increase; when the price level rises real wages will be smaller. A change in the price level will cause changes in the amounts of goods and services that a particular amount of money wages will purchase.

Q. 2. Explain why wage rates vary in (a) different occupations, (b) in different countries and (c) at different times. ( *B. Com*, 1941, 1939, 1935, 1931; *B. A.*, 1930. )

(a) If all occupations had been equally pleasant or agreeable and if labour could move freely from one occupation to another, there would have been no difference in wage rates in different occupations. But all occupations are not equally pleasant, nor is labour freely mobile as between one occupation and another. In some occupations, the worker finds great strain and disagreeable tasks; naturally, the flow of labour to these will be smaller than that to more agreeable occupations, causing wages to be higher in the former and lower in the latter. Differences in wages often equalise the unequal attractiveness of different occupations.

Besides, the flow of labour will be small to occupations

in which there is no regularity of employment and little prospects, in which the labourers feel no security and peace of the mind and in which long and costly training would be required. Wages in such occupations will have to be high to induce labourers to overcome the dissuading factors. On the other hand, labourers will flock to employments where there is a stable and regular income and where little or no training is required, and consequently wages in these occupations will be low.

Even if all occupations were equally agreeable and pleasant, there would have been differences in wages because of the *immobility of labour* from one occupation to another. Tradition, convention, social environments and a number of other factors combine to create *non competing groups* among labourers, making it sometimes impossible and often difficult for them to move from one occupation to another. Wages of each group, therefore, come to be fixed by the conditions governing the demand for and the supply of labourers in that group, and therefore, it is only natural that wages should vary from one occupation to another.

(b) The same immobility of labour explains why wages vary from one country to another. Labour cannot freely move from one occupation to another, there are similar obstacles in the way of the movement of labour from one locality to another. Differences of language, laws, social customs etc prevent people from moving from one country to another, and the universal preference of people for their own homeland is a contributory factor. Differences in

Immobility  
of labour

Non competing  
groups

Inter-regional  
immobility

climate and in racial stock may mean differences in efficiency leading to differences in wages ; but the main cause is found in the immobility of labour.

(c) Variations in wages at different times are caused similarly, either by changes in efficiency caused by the progress of time, or by changes in the number of labourers and in the distribution of labourers among different occupations. Wages are governed ultimately by the whole set of conditions affecting demand and supply, and naturally, variations are caused either by changes in the efficiency of labour or in the conditions affecting the supply of labour.

Q. 3. Discuss the following theories of wages : (a) Subsistence theory, (b) Wages Fund theory and (c) Residual claimant theory. ( *B. A., 1924, 1920.* )

Economists in the 18th and 19th centuries tried to explain wages by relating them to one single standard factor. Some tried to connect wages with the minimum necessary for the subsistence of the labourers, some with the capital available and some with the residue left after remunerating other factors of production.

(a) The *subsistence theory* or the *Iron law of wages* was the explanation given by Malthus and Ricardo. According to them wages would not in the long run remain above the minimum necessary for the subsistence of labourers nor would go below it. If the wages would ever rise above the minimum, marriages and births would increase resulting in a growth of numbers and a consequent fall in wages ; if wages would go below the minimum, the death rate would be greater, resulting in a fall in numbers and a rise in wages. Ultimately, therefore, wages would

be equal to the minimum necessary for the subsistence of the labourers

It is easy to realise the weaknesses of this explanation. As a matter of fact, wages today are often higher than the essential minimum and the theory is not, therefore, borne out by facts. The theory pays no attention to the efficiency of the labourers, and over-emphasizes the supply factors. And even here the theory is based on the Malthusian assumption that an increase in wages would automatically cause an increase in the birth rate. In the present-day world a rise in the wages would mean a decline in the rates of marriages and births.

(b) *The wage fund theory* was put forward by John Stuart Mill. According to him the play of economic forces would set apart an amount of wealth out of which wages would be paid. This amount stands in a rough relation to the volume of capital in the community and comes to be fixed irrespective of the number of labourers. The average rate of wages therefore, would be equal to the ratio between this wages-fund and the number of labourers, or roughly, between the volume of capital and the number of people. Wages can rise either if capital would increase or numbers decrease.

This theory makes the mistake of assuming that wages are paid out of capital, in fact, wages are *advanced* out of capital, but are *paid out* of the return of labour. Like the subsistence theory the explanation given by Mill also takes no account of the efficiency of the labourers, and besides, it fails to

explain the fundamental question how this wages-fund is created.

(c) *The Residual Claimant theory* tries to simplify the explanation of wages further by holding that rent, interest and profits are determined by laws relating to each and the labourers get what remains after all other payments have been made. In the case of the other factors, it is held, there is a supply price below which the remuneration cannot go and competition will force the remuneration to be equal to the supply price. There is no supply price of labour and hence labourers get low wages when a small surplus is available, and when their own output will be large they will be in a position to get high wages.

This theory, we may note, unduly simplifies the theory of wages, taking no account either of the efficiency of the labourers or of the distribution of labourers between different occupations.

Q. 4. How are wages determined? Explain the following: 'the rate of wages is determined by the marginal productivity of labour'. (*B. Com.*, 1937, 1930, 1929, 1928; (*B. A.*, 1940, 1931, 1917.))

Q. State and explain the productivity theory of wages. (*B. Com.*, 1944.)

Q. Explain the marginal productivity theory of wages. How far do you regard it as a complete explanation of the level of wages in a country? (*B. Com.*, 1942.)

Wages are the price paid for the services of labour and, like other prices, wages are determined by the conditions affecting the demand for labour and those affecting its supply. On the demand

Demand side

side we can relate wages to the marginal product of labour. Any factor tends to be used upto the point at which the productivity of the marginal unit just pays the entrepreneur for the additional expense incurred for that unit. When the entrepreneur experiments with the application of larger amounts of labour, he will experience a gradual diminution of the marginal output, and he will naturally stop expanding employment when the marginal output is on the point of being smaller than the wages to be paid. In equilibrium, therefore, wages are equal to the money value of the marginal product of labour.

In the case of other prices we find not only a set of governing conditions on the demand side but also on the supply side. In the case of wages, however, it is difficult to find out a definite supply price or a schedule of wages setting the minimum below which the labourers will not accept. The labourers are always at a disadvantage in their bargain with their employers on account of the lack of holding power, immobility and the extreme perishability of what they offer for sale in exchange of wages. The supply of labour within a particular group is more or less fixed, and even if demand changes, it is impossible for the labourers to adjust their supply accordingly. The labour market thus bears an analogy with the fish market where, on account of inflexibility of supply, demand is dominant and marginal utility fixes the price. In the labour market, too, the disadvantages of the labourers disable them from making effective their quotation of wages, unless, of course, they combine together, and consequently,

their wages come ultimately to be equal to their marginal productivity to the employer.

It can, therefore, be pointed out that the theory of wages is nothing *but an application of the general theory of value.*

|   |  |
|---|--|
| The theory of wages — and application of the theory of value [B. A., 1931.] | The price of anything is determined by the whole set of conditions governing demand and supply, and when one of the factors is inactive or passive, the other becomes the dominant determinant. The labour market is some sort of a "perpetual short period market" in which the supply is incapable of adjusting itself to changes in demand, and, as a result, the demand price as determined by marginal productivity takes the most important part in determining the value of labour. |
|---|--|

Q. The defence of the present system of distribution of income that it is in accordance with productivity that each gets the value of his contribution to wealth is an explanation merely and not a defence. Discuss. (*B. Com., 1944.*)

Under conditions of perfect competition, labourers earn wages measuring their marginal worth to the employer and capital earns the equivalent of its marginal net product. Marginal utility or marginal productivity estimate the nature of the social demand for a commodity or a factor. This social demand is itself caused by social habits, the structure of the community, the distribution of incomes, tastes and fashions, availability of resources, etc. The demand price for anything as determined by its marginal utility or marginal productivity is thus a result emerging from a number of causes working unconsciously upon one another and price under perfect competition is the result



of an unconscious process. The equilibrium price, therefore, is a *necessary* result of the forces operating, but not necessarily the most *desirable* result. When we say that the price of anything depends on marginal utility, we are merely offering an explanation and we are not defending the high price or the low price which results. Similarly when we say that wages depend on marginal productivity, we simply explain the genesis of wages in the particular type of society we know, we are not in any way suggesting that it is right that wages *should* depend on marginal productivity. Low wages are caused by low marginal productivity of labour and high rates of interest result from high marginal productivity of capital, but this does not imply that in our opinion wages should be low and interest should be high.

Q 5 What relation, if any, do wages have to the standard of life of the worker? (*B Com*, 1938, *B A*, 1940)

Q Examine the importance of the concept of standard of life in the theory of wages. How does that standard actually exert its influence on wages? (*B Com*, 1943)

Some of the earlier English economists tried to find out a direct causal connection between the standard of life of the worker and his wages. The 'subsistence' theory of Malthus and Ricardo, for example, was an attempt to show that wages would be directly determined by the minimum standard of life or 'standard of wretchedness' of the labourers. The subsistence theory has however, been sufficiently discredited and we

Subsistence  
theory

recognise to-day that no direct connection exists between the standard of life of the labourers and their wages. The mere fact of a high standard or a low one does not make wages automatically high or low.

But the standard of life does exercise an indirect influence on wages—through its effects on efficiency and on numbers. A high standard of life will mean that the labourers will be physically strong and technically well-trained and, therefore, their earning capacity will be great. Besides, this high standard will make the marriage-rate low, the age of marriage high and the birth rate low. This will keep the numbers steady and within limits. A high standard of life by causing increased efficiency and a low birth rate will indirectly cause a high rate of wages.

A low standard of life, on the other hand, will make the efficiency of the labourers low and is likely to make the birth rate high. Numbers are generally largest among the poorest and the most inefficient labourers. Their inefficiency, poverty and large numbers—all partially resulting from a low standard of life—make their wages low.

Thus, though no direct connection can be established between standard of life and wages, a high standard will bring about high wages and a low standard low wages, on account of the effects of the standard of life on efficiency and numbers.

Q. Indicate the forces that set higher and lower limits to wages. (*B. A., 1942.*)

The higher limit to wages, or the demand price for labour,

naturally depends on the productivity of labour. Given a particular supply of labourers, and a particular productive technique, employers will not pay more than what is their estimate of the marginal net product of labour. If they have to pay more, the marginal dose of labour becomes unremunerative and the margin rises.

The question of the lower limit raises difficulties. In the case of commodity prices the lower limit depends on the cost of production, because the producers have the option of producing or not producing. In the case of interest the lower limit depends on the marginal sacrifice involved in lending in preference to spending or hoarding, a choice is available to the lender, and he can balance his gains from spending hoarding and lending.

Ricardo and Malthus held that a lower limit to wages would be set by the subsistence minimum, for if wages go below this limit death-rate would increase, labour would become scarce and wages would be forced up. But the lower limit in the present day community rarely goes as low as this minimum. The standard of living is not a lower limit directly effective in the labour market, its effects on wages are exercised through efficiency, training and birth rate and naturally these influence only the long term trend.

For the ordinary labour who cannot turn from one occupation to another there is practically no lower limit of wages. His labour is extremely perishable and if he does not sell it today he cannot store it up for sale tomorrow. He has therefore to accept any wages that would secure employment to him.

Those labourers who can choose between one occupation

and another are in an advantageous position. For them, the lower limit to wages in any particular occupation is determined by what they could earn in alternative employments. An engineer who can earn Rs. 200 - p. m. in an iron and steel factory will not accept a railway employment on a salary lower than this. Similarly, a labourer who is solvent enough to balance the relative advantages of leisure and work will also set a lower limit of wages for himself; he will work only so long as the wages he gets are not lower than the loss of utility he suffers from the leisure he has to sacrifice. Most labourers, however, are not in a position to make such a rational choice.

Q. 6. Why are the wages of women low? (*B. A., 1918, 1917.*)

The wages of women are low mainly because of strong competition within a limited field. On account of physical weakness and social conditions, women can take employment only in a limited field, *e.g.*, in nursing, teaching, typewriting, etc. Within this limited field, all women seeking employment flock, and naturally employers take advantage of this competition.

Besides, women themselves offer their work at low wages because their requirements are smaller than those of an average adult male labourer. A male labourer has mostly to support a whole family. A woman supports only herself, or supplements her father's or husband's income. Together with all this, we may take into account the short duration of a woman's working life—often ending with marriage—and we get the cause which make their wages low.

Q 7 Discuss the function and utility of trade unions.  
(B A, 1938 1936 1922 )

A trade union is an association of labourers for securing common ends through united effort and collective bargaining. An individual labourer is always at a disadvantage in his bargain with his employer and the result of this weakness in the competitive position is that he gets low wages and strenuous conditions of work.

The functions of a trade union can broadly be divided into three categories. First it can act as a *fraternal association* of the labourers, trying to secure through co-operation what they cannot secure by individual effort. It can insure the members against the risk of accident or death, support them when ill or out of work, arrange for education of children and provide information regarding employment.

Secondly, a trade union is also a *militant* organisation—a body ready always to fight with the employers with the weapons of united action and collective bargaining. Strikes, boycotts and other devices are adopted to compel the employers to accede to the labourers' demand. Such concerted action is undertaken with a view to standardisation of wages and of hours of work and restriction of employment of non members.

Thirdly, a trade union often undertakes *political* duties to secure a fuller recognition of the rights of the labourers. Representatives are sent to the legislature to act as the mouthpiece of the trade unions. The growth of the Labour Party in Great Britain

has to a large extent been the result of the growth of the trade union movement.

From the above it is clear that the trade unions are of great utility to the labourers. A successful trade union will give its members assistance in many ways—make his employment secure, raise his wages, shorten his hours of work, and secure for him a proper place in the political field. It is, therefore, only natural that there would be in every modern country a rapid development of the trade union movement.

Q. 8. Discuss the effects of trade unionism on wages and conditions of labour. (*B. A., 1933, 1925.*)

Q. State the conditions under which a factor of production can permanently raise its remuneration. (*B. A., 1934, 1920.*)

The effects of trade unions on wages can be realised from a general analysis of the conditions under which a particular factor of production can permanently raise its remuneration. There is a joint demand for all factors, and if one of these, say labour, would restrict its supply it may sometimes be successful in securing for it a higher remuneration. If the labourers form a trade union and thus restrict their supply, the demand for other factors that are jointly used with labour will decline causing a fall in their remuneration. This may enable the entrepreneur to offer higher wages to the labourers.

The conditions under which labourers (or owners of any other factor) can raise their remuneration by restricting their supply are as follows: (a) The demand for the final commodity produced must be inelastic; otherwise the rise in the cost of produc-

to apportion for each group of labourers, its right share in the dividend

A sliding scale of wages, however justifiable theoretically, also fails for the same reason. The principle here is that wages should increase with a rise in the price level or in the cost of living and decrease with every decline in either. In practice, it proves unsatisfactory in either direction. Wages rarely rise high enough to compensate for the effect of high prices, on the other side, individual labourers and trade unions object to every attempt to lower wages in a period of falling prices. Socialists are against both profit-sharing and sliding-scale wages on the ground that these do not really solve the fundamental problem of the relation between labour and capital.

**Q 10** Discuss the conditions favouring a general high level of wages for all classes of labourers (B A, 1933)

Wages depend fundamentally on the efficiency of the labourers and on their numbers. These, in their turn, depend on a number of other factors. It is patent that a high degree of efficiency among a group of labourers will mean a high rate of wages, and it is also apparent that the employer will not lose if he pays a high rate of wages to labourers with great efficiency, the wage rate in such a case may be high, but the wage-charge per unit of output will be low.

This high degree of efficiency will prevail in a country where the standard of life is high—education widespread and technical training available to all labourers. To some extent, racial, physical and climatic factors also count.

Standard of life,  
education,  
training, etc.

But the mere possession of a high degree of efficiency is not sufficient. If the number of labourers is large, the *marginal* efficiency of labourers is bound to be low and this will naturally bring down the wages. We have again to note in this connection the importance of the indirect influence exercised by the standard of life of the labourers. The standard of life not only influences efficiency but also numbers through its effect on the rates of marriage, birth and death.

Among other conditions that make for a generally high rate of wages in a country, we may mention the growth of capital. After all, wages depend on the national dividend and anything that tends to increase this dividend will generally bring about at least some increase in the wage-bill of the labourers. New inventions and discoveries, new devices and technique, all tend to increase the dividend and hence wages.

It should also be noted that the wages in general can be made higher if arrangements are made to divert towards the labourers a greater share of the national dividend than what competition will bring to them. Trade Unions have this purpose of raising wages above the competitive equilibrium rate. State legislation regarding minimum wages, bonuses, short hours of work, holidays are all intended to bring about a diversion of this sort. And last of all, socialism is intended to make this diversion on a perfectly equalitarian basis.



Given a particular national dividend socialism undoubtedly secures the maximum possible general rate of wages

## Profits

Q 1 In addition to interest there are three important elements in profits the payment for undertaking risk, payment for management and organisation, and the revenue that can be derived from any restriction on competition" Explain and illustrate (*B Com, 1936, 1931*)

Q What are the constituent elements of profit? (*B A, 1939, 1928*)

Q How would you define profit? (*B A, 1944*)

Ordinarily the word profit is used to denote the whole of the entrepreneur's income, and is expressed as a percentage of the amount of capital invested by the entrepreneur. This tends to create a confusion between interest and profit, and it becomes therefore, necessary to distinguish clearly between what may be called *net profit* and *gross profit*.

When we use the word profit to denote the whole of the income coming to the entrepreneur, we ignore the fact that only a part of this income is due to entrepreneurial ability and efficiency, a large part is due to factors other than capacity for good management. A part of this income may represent interest on the money invested by the entrepreneur himself, another part may represent a reward for the risk undertaken by the entrepreneur, and there may be an element representing a monopoly gain secured by the entrepreneur. These elements in the income of the businessman arise on account of objective conditions independent of the superiority of business ability.

All these, together with *net profit* representing the return for the ability of entrepreneur, are the constituent elements of *gross profit*. The net profit is a payment for management and organisation, *i. e.* for the actual service rendered by the entrepreneur in creating and increasing the national dividend.

This *net profit* again includes two elements :  
 Net and Gross profits (a) a wage-element representing the competitive price of the business ability available, *i. e.* a minimum without which the entrepreneur will not work at all, and (b) a differential or rent element representing the superiority of a particular entrepreneur over the marginal producer.

This differential element may arise on account of certain differences in producing efficiency, and sometimes also on account of unfair advantages. One producer may earn a higher rate of profit than another because of superior power of co-ordination and management or of bargaining, or of undertaking and eliminating risks, or because of superior knowledge of market conditions and power of anticipation. Differential profits may also be earned by unfair methods like deception of consumers, cut-throat competition or methods of industrial terrorism.

✓ Q. 2. "Profits are a surplus of the intra-marginal over the marginal producer". "Profits are a constituent element of the normal price." Are these two views reconcilable? (B. A., 1935.)

The simplest explanation of profits regards it as a surplus arising on account of the superiority of a particular producer over the marginal producer. If a number of producers are

producing the same commodity for the same market, the price will ultimately come to be equal to the cost of production of the marginal producer. Those producers who are better than the marginal producer, or in other words, the intra-marginal producers, earn a surplus, because they are able to produce the article at a lower cost than that incurred by the marginal producer. Profits can thus be regarded as a surplus of the intra-marginal producer over the marginal producer, a result of 'lessened expenses within the margin'.

This is a refined statement of the well known 'rent theory of profits' popularised by Walker. This rent theory is quite an adequate explanation of the difference in profits : of the causes making the profits of one producer high and those of another low. But it tells us nothing about the minimum inducement necessary to keep the producer producing, the minimum which even the marginal producer has to earn in the long run. This minimum is the payment for the diversion of the entrepreneur's labour to a particular direction and it must be equal to the amount which the entrepreneur would have been able to earn in an alternative line. The supply of entrepreneurs will fall if this minimum is not earned and hence this minimum is a constituent part of the normal cost of production that the price has to cover.

Profits thus include two elements (a) a wage-element representing the minimum without which the entrepreneurs will not offer their services, and (b) a rent element representing the superiority of a particular producer over the marginal

Profits regarded  
as rent

Profits include  
a minimum  
wage-element

Wage-element  
enters price rent-  
element does not

producer. The first element enters into the normal price ; the second element being a surplus over cost, does not. It is easy, therefore, to see that the two views quoted in the question can be reconciled.

Q 3. Examine the validity of the two following propositions : (a) Profits tend to equality ; (b) Profits tend to a minimum. (*B. A., 1933.*)

Those who hold that profits tend to equality or to a minimum generally take a static view of society and try to find out what will happen in the long run if changes and fluctuations disappear. If society becomes entirely static, it is argued, differences will disappear and all profits will become equal at the minimum level represented by the wages of the entrepreneur for their labour of management and organisation.

This static view of society and of profits is entirely erroneous and unreal. Society is always in a dynamic condition and it is impossible to conceive of an entirely static future when all differences have disappeared and changes ceased. Changes in methods and technique, new inventions and discoveries will always take place and there will always remain differences between one producer and another. Profits would, therefore, never be equal or come down to the minimum possible level for all producers so long as the present economic structure is maintained. There would not even be a perceptible trend towards equality or the minimum level because by the time one differentiating factor has exhausted its influence, a new set of differentiating factors are sure to have cropped up.

Static view—  
erroneous and  
unreal

Q 4 A grocer expects a profit of 25 per cent on his turn over while a wholesale dealer in jute is satisfied with a profit of 1 p.c. or even less. How would you explain this ? ( B A , 1928 )

The producer of a commodity is more interested in the aggregate net profit earned by him than in the rate of his profit. He may earn a large total income if he is able to sell a large quantity at a low rate of profit per unit, and his income may be low even when the rate of profit is high if only the sales are small. A village grocer expects a high rate of profits because his total business is small, a wholesale jute dealer deals in lakhs of rupees, and even a one per cent profit would give him a large income.

Besides, the *rate of turn over* also counts. A grocer buys his wares from a wholesaler and takes perhaps three or six months to sell this stock. He is able, —and has a rapid turn over— therefore, to utilise his working capital only twice or so in course of a year. A wholesale dealer can have a very rapid turn-over. He may purchase jute on a particular day for a lakh of rupees, sell it the next day at 1% profit and thus make a net income of Rs 1000. The very next day he may again purchase from the cultivators another lakh of rupees worth of jute and sell this on the day following at a profit of 1%. In this way, if he can make a profit of 1% on a lakh of rupees every three or four days, his total income will be very big.

The big wholesaler, therefore is satisfied with a low rate of profits because he deals with a large amount of money and has a rapid turn-over. The small trader handles only a small amount of working capital and experiences a slow

turn-over ; his *rate* of profit has, therefore, to be high in order to make it worth his while to run his business.

Q. 5. How would you find out profit (a) in the case of a private firm and (b) in the case of a joint-stock company ? ( *B. A., 1944* ).

(a) In the case of a private firm, the profits generally are taken to include the remuneration for the owner's own labour and for other factors supplied by him. The net profit should be calculated after excluding all these, but private firms do not generally distinguish between net profits and gross profits. Whatever remains after the outgoings have been deducted from the gross receipts is recorded as profits.

(b) In the case of a joint stock company a more careful estimate is made. Proper deduction is made not only for the remuneration for management, but also for depreciation, wear and tear. A part of the gross profits is also usually transferred to the reserve fund. The remainder is distributed among the shareholders as net profit or dividend. A part of this dividend should, strictly speaking, be regarded as interest on the capital supplied by the shareholders, but this distinction is not usual in a society in which ownership in the firm comes through ownership of capital.

### MISCELLANEOUS

Q. 1. Distinguish between rent and quasi-rent. Write a note on quasi-rent. ( *B. A., 1937. 1926.* )

Rent is the name given to the differential income earned by land on account of its scarcity and its superiority over the land on the margin of cultivation. Capital goods may also present the same characteristics for a short period of time. The rival pro-

ducers of a particular commodity will all try to reduce cost but it is likely that one of them will be able to get a

temporary hold over some superior capital good that others cannot get. The producer

owning this superior capital good will be able to get a surplus on account of lowered cost of production so long as

others are not able to purchase this particular machine. Quasi rent is the name that we give to such incomes derived

from fixed capital and it is easy to realise that such incomes partake of an element of rent when a particular capital good

is scarce for the time being.

The difference between quasi rent emerging from capital goods and rent of land is that the differential return in

quasi rent arises on account of a short period limitation of supply while rent proper arises because of long period

scarcity of natural resources.

✓Q 2 Show that there is a rent element in wages interest and profits (B Com 1933)

Q The rent of land is seen not as a thing by itself but as the leading species of a large genus. Amplify (B Com 1942)

Q The difference between rent interest and wages is one of degree only (Clay). Explain (B Com 1934)

Q How far is it practicable to form a theory of wages parallel at all points with the theory of rent? (B Com 1945)

Q Rent of land is the most obvious but not the only case in which an income is derived from differences in the productivity of an agent of production which are not due to the persons who supply that agent of production (B Com 1944)

All rewards of factors of production can be analysed from the standpoint of relative scarcity with respect to given time-periods. The scarcity of good land gives rise to the rent of land; similarly, scarcity of any other factor would be able to create a 'rent' element in the reward. Land rent, therefore, is the leading species of a large genus which includes all differential incomes whether earned by capitalists, entrepreneurs or wage-earners.

A temporary scarcity of a particular sort of labour may give that class a differential income or a 'rent of personal ability'. A great surgeon, a great musician or a great boxer can earn incomes higher than others of their class on account of their superiority over the 'marginal' surgeon, the marginal musician or the marginal boxer who set the standard of the general income level.

It has been argued that it is possible to form a theory of wages parallel at all points with the theory of rent. Just as there is a minimum rent for every land determined by the possibilities of earning from alternative uses, there is a minimum wage-rate for every group of labour in so far as it is possible for them to move to alternative occupations. And just as scarcity of superior types of land causes a differential rent, scarcity of superior types of labour also causes a differential income. But the analogy cannot be carried far. The supply of land is more inelastic than the supply of labour and on the other side the scope for movement of labour from one occupation to another is gradually becoming more and more restricted.

The rent-concept has been applied over an extensive field. All classes of capital goods are not of the same degree



of productivity      If the most productive capital goods are  
 —in the return      scarce too, they will be able to yield an  
 from capital      income higher than what capital in general  
                          would earn      That is to say, the quasi rent  
 from such capital goods will be greater than what would  
 represent the normal earnings of capital

The entrepreneur's income also includes a rent element  
 on account of the existence of differences in ability between  
 —in profits      one another, and of the scarcity of good  
                          entrepreneurs      All entrepreneurs in the  
 long run can expect to get a minimum profit equivalent to  
 what they could have earned in alternative employments  
 —a minimum without which they will not have any induce-  
 ment to continue production In addition to this the  
 efficient producers are able to get a surplus—representing  
 their superiority over the marginal producers Profits,  
 therefore, include (i) a price element or a normal element,  
 and (ii) a rent element or an element of surplus

All incomes are, therefore, essentially alike There is in  
 each case a minimum income that has to be given to the  
 factors in order to induce and maintain their supply and  
 in addition to this there is a surplus available to those units  
 of the factors which are more productive than the marginal  
 units

**Q 3** Explain why an increase of population tends to  
 lower wages but not rent (B A 1941)

An increase of population would mean an increase in the  
 number of labourers and the usual effect of this will naturally  
 be to bring down the rate of wages Wages  
 Increased supply      depend upon the sets of conditions govern-  
 will lower wages      ing demand and supply, and, when other

things remain unchanged, an increase in the supply of labour can only lower the rate of wages.

But it may happen that an increase of population means a more than proportionate increase in the total production of wealth. This will be particularly so in Exception a new country where resources are lying unutilised and the number of people is small. In such a country where the law of increasing returns will have a comprehensive operation, wages may rise as the result of an increase of population. In general, however, it remains true that an increase of population tends to lower wages.

The effect of an increase of population on rent will be to increase it. A large population will mean an increased demand for food materials and other agricultural products and this will result in an extension of cultivation. The margin of cultivation will, therefore, recede and, consequently, the rent of super-marginal lands increases. When all lands have been taken up, an additional scarcity-rent will come to be earned from land. An increase in population thus has the general tendency of lowering wages and increasing rent.

Q. 4. 'High wages and high prices do not necessarily go together.' Comment on this statement and bring out the relation between wages and cost of production. (*B. A., 1934.*)

It is generally assumed that high wages would mean high cost of production and, consequently, high prices of the articles produced. It is on this assumption that high-wage countries generally impose tariff duties on goods coming

|  |  |
|--|--|
| Wages per<br>labourer and<br>Wages per unit<br>of output | from low-wage countries. A little reflection, however, shows that the cost of production of a commodity would depend not on the wages paid per labourer but on the wages paid per unit of output. If the labourers earning a high rate of wages are very efficient : <i>e</i> if they can turn out a large output, the cost per unit of the commodity may be low. If in one country labourers earn on the average Rs 5 per week and if in another the average wages are Rs 10 per week, and if the efficiency of the labourers in the second country is three times as great as that of the labourers in the first, the cost per unit of the articles produced will be lower in the latter country than in the former. |
| High wages may<br>go with low cost                       |  |

There is, therefore no direct causal connection between high wages on the one side and high cost or high prices on the other. If high wages had inevitably meant high prices, there could have been no international trade between a high-wage country and a low wage country. The existence of such trade is ample proof of our conclusion that high wages do not necessarily mean high prices.

## CHAPTER VII

### Money

Q. 1. What is money? Describe its chief functions. 'Money is as money does'. Explain. What are the different forms of money? (*B. Com.*, 1929, 1928; *B. A.*, 1940, 1920.)

By money we mean anything that is accepted as a common medium of exchange by all. The inconveniences of barter led people to devise something that would serve as a medium of exchange, a measure or common denominator of values, a means for storing and transferring value and as a standard for deferred payments. After experiments with different materials, gold, silver and bronze came to be accepted as the most suitable material for use as money.

The modern world has, however, found even the use of gold and silver cumbersome and wasteful, and as a result various other forms of money or substitutes for money have come into use. Paper notes, cheques, bills of exchange are all serving today either as money proper or as substitutes for money.

The functions of money are mainly fourfold: First, money acts as a medium of exchange in all transactions; secondly, it is a common standard by which all values can be measured and compared; thirdly, it is a means for storing value and transferring value; and lastly, money, being comparatively stable in value, serves as a standard of deferred payments.

It may, therefore, be held that anything that performs these functions is money. Whether the material used by the people to serve as a medium is a piece of leather or rice or a gold coin or a scrap of paper, it is money so long as it performs the functions of money. This is what is meant by the statement, "money is as money does."

Q 2 The following classification of money is given in your text book (Fairchild Furniss and Buck) - 1 Standard Money 2 Representative money 3 Credit money (a) Token money (b) Government notes (c) Bank notes 4 Fiat money Explain and illustrate these classifications (B A, 1942)

The term *Standard Money* is used to denote those the exchange value of which depends on the material of which they are made. The face value of the standard money is exactly equal to the market value of the bullion it contains. Such units of money are rarely used nowadays. The British sovereign before 1931 and the Indian Rupee before 1893 were examples of standard money.

By representative money is meant receipts issued by the government declaring that it is holding standard money to the full extent of the amount mentioned on the face of the receipts. These receipts or certificates are redeemable on demand, and they circulate at the same value as that which they represent.

Credit money involves a faith or trust in the issuing authority. A token coin (e.g. our eight anna bit) circulates at a value much above its intrinsic value, and this it does because the people have confidence in the ability of the government to maintain the value of these coins. A govern-

ment note that is not fully backed by standard money ( *e. g.* our ten-rupee notes before the Reserve Bank was established) and a Bank note ( our present two-rupee, five-rupee or ten-rupee notes ) also circulate because of the credit enjoyed by the issuing authority. The Reserve Bank of India, for example, keeps a 40% reserve against the notes issued, and of this 40%, the major part nowadays is not gold but obligations of the British government. These notes circulate because of the trust reposed by the public on the solvency of the Reserve Bank.

By Fiat money we mean money that has no intrinsic value and no definite backing, but is circulating because of the fiat or order of the sovereign authority. Such notes are naturally inconvertible, but they can be of service so long as there is no excessive issue. The present one-rupee notes of the government of India are good examples of fiat money. These circulate because of a government order making them legal tenders and are nevertheless very convenient, at least for the urban population.

It is to be noted that no classification can be regarded as perfectly sound. It would not be illogical to hold that all categories of credit money should be brought under the class of representative money and that fiat money is credit money carried to its logical extreme. The alternative Keynesian classification of all money into state money and bank money and the further divisions of state money into commodity money, managed money and fiat money are more convenient for the purposes of monetary theory.

Q. 3. Explain the law of Gresham showing the cases where it is inoperative. (*B. Com.*, 1930, 1928, 1927; *B. A.*, 1943, 1920, 1927.)

Sir Thomas Gresham, a contemporary of Elizabeth, noticed that if good and bad coins were put into circulation together people would use the good coins for hoarding, melting or paying foreigners and pass the bad ones into circulation. As a result only the bad ones would circulate and the good coins would disappear from circulation, bad money would thus drive good money out of circulation.

As a general tendency, Gresham's law is perfectly true. If people have two alternative methods of doing the same thing they will naturally choose the cheaper one. If good money and bad money would both be legal tenders for internal circulation, people would naturally use the latter for internal transactions. For hoarding, melting and payments abroad, bad money would be unsuitable, and consequently, good money would be diverted to these uses.

The law would operate under a number of different circumstances. When depreciated paper and metallic money are in simultaneous circulation, paper alone would ultimately circulate and metallic money disappear into boards or into the melting pot or be sent abroad. When debased coins and fresh coins are both sought to be circulated, the former would naturally drive out the latter from circulation.

The most important case of the operation of the law of Gresham is obtained when gold and silver are concurrently issued under a bimetallic standard. If there is a disparity between the 'mint' ratio and the 'market' ratio, one of the metals would be 'overvalued' at the mint, and everyone would take that metal to the mint and the other metal to the market. The

'overvalued', metal would thus drive out the 'undervalued' one from circulation. [ See the answer to the question on "Bimetallism." ]

The law of Gresham, however, will not operate unless certain conditions are fulfilled. *First*, the supply of bad money and good money taken together must be more than what is necessary to meet people's demand for money ; otherwise people will have to use both good and bad money. *Secondly*, the bad money must not only be full legal tender but also accepted by the people ; if people refuse to accept the bad money, as the Californians refused to accept the 'Greenbacks' during the American Civil War, the law would become inoperative.

Q. 4. What do you understand by the value of money ? How is the value of money determined ? (*B. Com.*, 1936, 1933, 1929 ; *B. A.*, 1930, 1932.)

Q. Explain clearly the relation between the quantity of money in circulation and the general price level. (*B. Com.*, 1939, 1938, 1936, 1931, 1929 ; *B. A.*, 1938, 1933, 1926, 1922.)

Q. Indicate the factors that determine the general price-level of a country. (*B. A.*, 1944.)

By the value of money we mean its purchasing power, i.e. the power which it has of commanding other things in exchange. This value or purchasing power of money is obviously the reciprocal of the general price level. A rise in the value of money, i.e., *appreciation*, means a fall in the price

Appreciation and  
Depreciation



level, while a fall in the value of money, i.e. *depreciation*, means a rise in the price level

The value of money, like the value of any other commodity, depends fundamentally on its demand and supply. There are, however, dissimilarities, the demand for money

depends on a large complex of factors, and

Demand and Supply      on the supply side it is difficult to correlate the value of money with its cost of pro-

duction But in spite of these differences, the fundamental influence of demand and supply on the value of money is just as it would be in the case of the value of any other commodity

Older economists tried to find out a direct connection between the supply of money and the value of money by the famous *Quantity Theory* According to them the price level will vary directly and the value of money indirectly, with changes in the supply of money A large supply of money will mean that each unit of commodities will exchange for a larger amount of money, and hence, prices will rise and value of money fall, a shrinkage in the supply of money will lead to a fall in the price level and a rise in the value of money

This bald statement of the relation between the supply of money and the price level has been considerably modified by the present day writers It has first of all come to be recognised that the price level depends as much on the

The goods side      quantity of commodities or the number of transactions as on the quantity of money.

The total demand for money in any country will depend on the number of transactions and on the average price to be paid for each transaction

The supply of money does not consist merely in the quantity of 'official' money in circulation. If credit instruments are circulating, they add to the volume of purchasing power and they have to be considered in reckoning the total supply of money. Besides, it is to be noted that one unit of money circulating twice can do the same work as two units of money circulating once each. Thus, the velocity of circulation of money and of credit instruments have also to be taken into account.

We can thus analyse the factors governing the demand for and the supply of money, and correlate them by a simple equation, after Irving Fisher. The total demand for money is represented by  $PT$  where  $P$  stands for the average price and  $T$  for the number of transactions. The total supply of money is represented by  $MV + M'V'$ , where  $M$  stands for the quantity of money,  $M'$  for the quantity of credit instruments, and  $V$  and  $V'$  for their respective velocities of circulation. As  $PT$  represents the total expenditure of all men upon all commodities, and as  $MV + M'V'$  also does the same,  $PT$  must be equal to  $MV + M'V'$ , i.e.  $P$  or the average price is equal to  $MV + M'V'$  divided by  $T$ .

The price level thus depends on a multitude of factors, and any change in any one of these can bring a change in it. The price level rises, i.e. the value of money falls, if the number of transactions becomes smaller, or if there is an increase in the quantity of money, the quantity of credit instruments or in their velocities of circulation. The price level falls, i.e. the value of money rises, when transactions

increase or when there is a decrease in the quantities of money and credit or in their velocities of circulation.

Q 5 Examine the economic effects of rising prices (inflation or depreciation of money) and falling prices (deflation or appreciation of money) ( *B A, 1937, 1928, 1918* )

Q Examine the effects of a depreciating currency on inland trade ( *B Com, 1943* )

Q What is meant by inflation of currency? Examine the effects of inflation on the production and distribution of wealth ( *B Com, 1941* )

Rising prices, inflation and depreciation of money mean the same thing, just as the same meaning is conveyed by falling prices, deflation and appreciation of money. To study the effects of rising and falling prices, we have to divide society into a number of groups and study separately the way in which each group is affected. The main interests to which we can look are those of the creditors, the debtors, the wage-earners, the fixed income class, the employers and the state exchequer.

✓ When prices are falling, a given amount of money will represent an increasing amount of goods and hence when a debtor has to repay a particular amount of money, he returns a larger amount of goods than he borrowed. At the time of falling prices, therefore, the debtor loses and the creditor gains. When prices are rising, the debtor gains and the creditor loses because the repayment of a given sum of money represents the return of a smaller volume of goods. In the

Debtors and  
Creditors

case of new loans, however, the creditor will be able to make good his losses. The rate of interest will naturally rise in a period of higher prices. Again when prices are falling, the interest rate will fall and this will affect the creditor in respect of new loans granted by him.

The wage-earners lose individually but gain collectively in a period of high prices. Wages do not rise as fast as prices do, and consequently, labourers in employment find that their real wages have fallen. But as a class they gain, because a period of higher prices is a period of increasing employment. When prices are falling, the real wages of labourers who remain in employment increase, because money wages do not fall as rapidly as prices do ; but as a class labourers lose because employment is sure to decline.

Those earning fixed incomes naturally gain when prices are falling, and lose when prices are rising. The number of such persons, however, is relatively small in every country.

The employers gain in a period of rising prices and lose in a period of falling prices. When prices are rising, producers gain, first, because their costs (mainly wages) do not rise as fast as the prices of the finished products, and secondly, because there is an interval between the time of incurring the expenses and that of selling the output ; when prices are rising, a margin of profit will be created by the rise of prices during this *time-lag*. In a period of falling prices, employers lose because costs do not fall as rapidly as prices and also because any delay in selling

the output would mean a further decline in prices and consequently in profits

The State exchequer gains in a period of high prices because it experiences an increase in tax receipts. The Government receipts from income tax, customs and excise will all increase when activity and incomes increase on all sides. The expenses of the Government do not increase as rapidly as tax receipts do. In a period of falling prices on the other side tax receipts decrease but expenses do not decrease to the same extent besides in extreme cases relief expenditure may be necessary. The budget of the Government is therefore likely to be unbalanced in a period of falling prices.

Depreciating currency or rising prices thus have a stimulating effect on inland trade in the initial stages. But depreciation is a spiral process—each step forward necessitating a new step and the result is that ultimately currency depreciates so much and prices rise so high that people lose all faith in the currency. A flight from the currency begins and trade comes to be entirely disorganised.

**Q 6** How would you measure changes in the price level or variations in the purchasing power of money? (*B Com 1941 1936 B A 1935*)

**Q** What precautions are necessary in using Index Numbers as a test of changes in the purchasing power of money? (*B A 1927*)

By the price level we mean the general average of all prices—a figure representing the broad trend of prices in general. This price level would be easy of measurement when all prices move forward or backward in the same pro-

portion. But as this does not happen, i.e. as prices of different commodities change in different degrees, it is necessary to apply some method of averages to find out the general price-level.

The simplest method is that of taking the arithmetical average of the degrees of changes in the prices. First, we have to select a base year, the prices in which are to be taken as the standard of comparison. Then, the prices in the year under review have to be expressed as percentages of the prices in the base year, that is, each price in the base year is to be taken as equivalent to 100 and the corresponding price in the other year is to be expressed as a ratio of 100. When all figures have been calculated in this manner, the average has to be obtained in the following way :

| <i>Commodities</i> | <i>Prices in 1938<br/>( base year )</i> | <i>Prices in 1945</i>             |
|--------------------|---|-----------------------------------|
| Rice per md.       | 5/- = 100                               | 16/- = 320                        |
| Sugar per md.      | 10/- = 100                              | 15/- = 150                        |
| Cloth per yd.      | 1/- = 100                               | 2/8 = 250                         |
| Salt per md.       | 4/- = 100                               | 7/8 = 187.5                       |
|                    | Total = 400                             | Total 907.5                       |
|                    | Average $400 \div 4$<br>= 100           | Average $907.5 \div 4$<br>= 226.9 |

Taking 1938 as the base, the *Index Number* for 1945 is found to be 226.9 showing that in course of three years there has been on the average a 126.9 per cent increase in the general price-level.

Such an index number calculated by taking simply an

arithmetical average of percentage changes in the prices conceals the relative importance of commodities. All commodities are not equally important to us, and, therefore, a 10 per cent increase in the price of rice matters more to us than a 50 per cent increase in the price of sweets. In constructing Index Numbers, it is necessary, therefore, to make allowance for the relative importance of different commodities, this can be done by giving to individual commodities proper *weights* in accordance with their relative importance.

A *weighted* index number can be constructed when we know how to measure the importance of commodities. This is usually done by taking into consideration the total expenditure of consumers on different commodities. If, for example, we find that salt is twice as important as sugar, cloth three times, and rice 5 times, we can give to sugar, salt, cloth and rice the weights of 1, 2, 3 and 5 respectively, and correct our index number as follows:

| Commodities | Prices in 1938<br>(base year) |                      | Prices in 1945 |                        |
|-------------|-------------------------------|----------------------|----------------|------------------------|
| Rice        | 5                             | $100 \times 5 = 500$ | 16             | $320 \times 5 = 1600$  |
| Sugar       | 10                            | $100 \times 1 = 100$ | 15             | $150 \times 1 = 150$   |
| Cloth       | 1                             | $100 \times 3 = 300$ | 2.8            | $250 \times 3 = 750$   |
| Salt        | 4                             | $100 \times 2 = 200$ | 7.8            | $187.5 \times 2 = 375$ |
|             |                               | 1100                 |                | 2875                   |
|             |                               | Average              |                | Average                |
|             |                               | $1100 \div 11 = 100$ |                | $2875 \div 11 = 261.4$ |

Here every figure has been properly *weighted* and the average has been obtained by dividing the total by the sum of the units of weight ( $1+2+3+5=11$ ). After giving due consideration to the relative importance of the articles we find that there has been a  $161\frac{1}{4}$  per cent increase in the price level.

No index number is, however, perfect. The *first difficulty* arises in connection with the selection of a base year. The base year has to be a fairly stable one and yet not one very much far away from the other years. The *Second difficulty* arises in the selection of commodities. It is impossible to take into account every commodity in the market. It is, therefore, necessary to exercise special care in selecting commodity so as to make the Index Number as representative as possible. *Another difficulty* may arise on account of the changes in the nature of the commodities themselves; commodities that were in common use in the base year may have gone out of use in the year under review and new inventions and discoveries may have led to the incursion of new commodities. Then, *again*, it is difficult to estimate correctly the exact weight to be attached to the commodities selected—there is no absolutely correct method of doing so. *And, lastly*, we have to be careful about the method employed; as we have to take average of proportions, the arithmetical average is not always suitable. The best result is obtained when a *geometrical average* is taken. (The geometrical average of  $n$  figures, it may be noted, is the  $n$ th root of the product of all these  $n$  figures.)



Q 7 Compare the merits and demerits of different types of paper money ( *B Com., 1936* )

Q Explain and comment on the fixed fiduciary system of note issue ( *B Com., 1943* )

Paper money is used as a substitute for metallic money with mainly two ends in view—facilitation of handling big amount of value, and economisation of precious metals. It is usual to keep a certain proportion of reserve against every type of note-issue, and the different manners of keeping the reserve give different names to these forms.

The simplest form of note issue is what Fisher would call "hundred percent money" i.e. notes backed by full bullion reserve. These notes are undoubtedly very safe and secure and they also eliminate the probability of over issue. But the system is wasteful and uneconomic and makes one of the main purposes of note issue entirely nugatory.

The traditional British system has been the *fixed fiduciary* system. Under it, fiduciary notes i.e. notes not backed by bullion reserve can be issued up to a fixed limit and when this limit has been reached, every additional issue must be fully backed by reserve in bullion. This system is a compromise between the *Banking Principle* of keeping only the minimum reserve consistent with safe convertibility and the *Currency Principle* of ensuring convertibility throughout. The system has all the advantages and disadvantages of a compromise. So long as it is properly worked it is as good

as any other system ; but it is easy to see that if the total note issue is very small this system would make the reserve unsafe and if the total is very large the reserve will be wastefully large.

In some cases attempts have been made to give full discretion to the note issuing authority in respect of the reserve ratio. A *maximum limit* of the total note-issue is fixed and the issuing authority is left free to decide what proportion of reserve should be kept. In the hand of an unscrupulous issuing authority such system may be dangerous ; in the hands of a sound authority such a system will provide elasticity and safety simultaneously.

The most scientific method, and the most commonly adopted one is the *proportional reserve* system. Under this system the note issuing authority is to keep a minimum reserve of a certain percentage of the total note issue. The most commonly used ratio is the 40 per cent ratio ; this ratio has been accepted as the standard in the U. S. A., Germany and also in India. In order to allow some elasticity, arrangements are often made for lowering the ratio in times of emergency.

Before concluding we may note that the note issue may also be absolutely inconvertible. Such notes may be made to circulate by the command or the *Fiat* of the Government, and if issued in limited quantities they may serve the purpose of money quite efficiently. But the danger of over issue is always there, and it is this danger that should be considered when embarking on a policy of inflation by issuing inconvertible notes.

Q 8 Point out the modifications introduced in the system of note issue in Great Britain by the Currency and Bank notes Act of 1928 " (*B Com.*, 1943)

The Fixed Fiduciary system of note issue was introduced in Britain by the Bank Charter Act of 1844 which allowed a maximum of £14 million of fiduciary notes. This limit had been raised from time to time until it stood at £19 50 000 in 1923. Special provisions were made for increasing the issue during 1914-18 and banknotes were supplemented by treasury notes of small denominations. The actual fiduciary issue at the end of the first world war was gradually reduced according to the recommendation of the Cunliffe Committee and later following the recommendation of the committee on the Currency and Bank of England Note Issues (1925), the Currency and Bank Notes Act was passed in 1928.

This act maintained the fixed fiduciary system. The Issue Department of the Bank of England was to issue notes against gold reserves at the rate of £3 17s-10½d for every ounce of gold held. In addition fiduciary notes to the extent of £260 millions could be issued.

An element of elasticity was introduced by empowering the Treasury to raise or lower the fiduciary limit on application from the Bank. The Treasury could grant such permission for a period of six months with power to renew it upto two years after which parliamentary sanction would be necessary.

A third important provision was that the Bank's net profit from the Issue Department (arising from incomes of the securities held against the fiduciary issue) was to go to the government as a public revenue.

Fundamentally, the principle of the Act of 1844 were adhered to. The Macmillan Committee held that the Act of 1928, although it greatly enlarged the amount of the Bank of England's fiduciary issue, and imported a measure of elasticity, confirmed as a normal arrangement the essential provision of the Act of 1844.

Q. 9. Give a brief account of the provisions of the British Currency and Bank notes Act of 1939.

*Changes were made in the fiduciary limit after the suspension of the gold standard in 1931, but these changes were all made according to the Act of 1928. The statutory maximum of fiduciary issue remained at £260 millions and the actual changes made were all technically temporary. And, in spite of the rise in the market price of gold, the Bank of England had to value its reserves at the rate of £3-17s. 10½d. per ounce. The Act of 1939 fixed the fiduciary limit at £300 millions in place of £260 millions. (The actual temporary limit had in 1939 come up to £400 millions). An important change was that gold was to be valued at the prevailing market price. As this price was much higher than the old statutory price, the gold reserves would show an excess. The Act provided that any excess of the gold reserves over the total value of notes would be made over to the Exchange Equalisation Account, and that the latter would conversely make good any deficiency.*

The Act came into operation in March, 1939. The war, however, changed every thing. The gold reserve in the hands of the Bank is now negligible and practically the whole note issue in Britain has become fiduciary. The limit has been raised in instalments, and now it is above £1000 millions.

**Q 10** "An inconvertible note issue is a special case of monopoly value" Comment (*B A, 1922*)

An inconvertible note issue has no intrinsic value of its own. It first comes to have whatever value the issuing authority gives it, later it comes to have whatever value the market conditions determine for it. If the Government would keep the supply of notes within limits it can maintain the value of these notes and if the supply becomes very large naturally prices will rise and money will depreciate. The value of inconvertible paper notes thus depends on the ability of the Government to restrict the issue of notes. It thus is a special case of monopoly value because monopoly value is fundamentally dependent on the power of the monopolist to regulate the supply of the monopolised commodity.

**Q 11** Discuss the comparative merits of the issue of paper currency by banks and by the Government respectively (*B A, 1927*)

It has come to be generally recognised today that paper currency should be issued by the central banking institution of a country. The issue of paper notes by the Government has no doubt some advantages. People naturally have more confidence in the Government than in a bank, the Reserve Bank notes for example have to be guaranteed by the Central Government of India. Then again it is held that if there is any profit from note issue that profit should come to the Government & ultimately to the people. It may also be argued that the control of currency should belong to the body that controls everything else.

On the other side it may be pointed out that history warns us against giving the Government the monopoly of note-issue; there have been *very few Governments* that have

Demerits                      been able to overcome the temptation of inflating paper currency in times of need.

Besides, the composition of a modern Government based on the party system is always fluctuating; it is desirable that the note-issuing authority should be a continuous and stable body and that currency policy should be above party politics. It may also be added that currency policy should be linked up with the requirements of trade and industry and this can best be done by a body intimate with the markets.

In discussing above the arguments against Government issue of notes, we have, in a sense, given arguments in favour of issue by a bank. A paper currency issued by a Central

Central Bank                      Bank would be above party politics, would  
notes                      follow a systematic policy, would be free from the danger of inflation, and lastly, would be adjustable to the needs of the businessmen.

It is, however, possible that a bank having the power to issue notes will not exercise the power with a view to securing the *best interests of society*. A bank is a private institution and it may be difficult for it to resist the temptation of making profits at the cost of the social interests.

This danger does not, however, raise any insuperable difficulty. It only points out the need for good legislation for regulating the note-issue. It has come

Controlled                      to be recognised today that the best  
Central Bank                      system of note issue is one undertaken  
notes                      by a central bank working within the

bounds set by well-devised legislative measures.

Q 12 Explain the difficulties of maintaining in circulation together two metals at a Mint Ratio different from their Bullion Ratio ( *B Com., 1939* )

Q Discuss the essential features of bimetallicism and describe its chief advantages and disadvantages ( *B A, 1937, 1929, 1925, 1920* )

The problem of the standard has always been a difficult one. Bimetallicism had for a long time been recognised as a suitable monetary system, and it was only towards the close of the 19th century that bimetallicism came to be given up in favour of a monometallic gold standard.

A bimetallic currency implies that there would be two metals circulating together—both being used as standard coins, i.e. both being fully legal tender and freely minted. The Government would maintain a fixed ratio between the two metals.

It may be pointed out that a bimetallic standard would secure the advantage of an adequate supply of money. If Advantages the standard currency is made of only one metal, the supply of money may prove insufficient and this insufficiency can be remedied by the simultaneous issue of two metals. It is argued that this would secure a stability of the price level.

It is also pointed out that bimetallicism would stabilise the exchange rate between gold standard countries and silver standard countries and that it would do away with the undesirable effects of fluctuations in prices and exchanges.

The greatest disadvantage of the bimetallic system arises from the difficulty of maintaining a fixed *mint ratio* between gold and silver when the *market or bullion ratio* is constantly fluctuating. The operation of the law of Gresham in cases of such disparity would convert a bimetallic standard into an *alternating monometallic system*.

If, for example, the mint ratio is 1 : 15, i.e. if at the mint one ounce of gold is taken as equivalent to 15 ounces of silver, and if in the market a sudden influx of silver makes it possible to get 16 ounces of silver in exchange of 1 ounce of gold, everyone would melt his gold coins, bring this gold to the market, get silver in exchange, and then receive silver coins at the mint in exchange of this silver bullion. For every ounce of gold, it would be possible to make a profit of one ounce of silver. Ultimately, gold coins would disappear and silver coins would alone remain in circulation.

On the other side, if an increase in the supply of gold in the market makes gold relatively cheap, gold will flow to the mint and silver to the market, and a gold monometallism will replace bimetallicism.

This is the greatest difficulty of bimetallicism. It is always likely that the bullion ratio in the market would be different from the mint ratio sought to be maintained by the Government and this would make bimetallicism incapable of functioning properly.

Of course, it is argued that there is a "compensating action of the double standard" leading to the establishment



of a parity between the mint ratio and the market ratio. If silver becomes cheap in the market silver would go to the mint and gold will flow into the market. This very tendency may raise the value of silver and lower the value of gold bringing back the normal parity. But such action will be slow in operation and by the time one disturbance has been corrected a new one may have set in leading to a fresh disparity.

Bimetallism has been found unpracticable in most countries. The incursion of gold in the world markets in 1848 and the increase in the supply of silver in the seventies of the last century both proved the futility of trying to maintain bimetallism. Bimetallism therefore had to disappear and give place to the gold standard.

Q 1 When is a country said to be on the gold standard? There are degrees of the gold standard. Illustrate the statement. (*B Com 1940*)

Q What are the essential characteristics of a gold standard? Explain the distinction between a gold bullion standard and a gold exchange standard. (*B Com 1937*  
*B A 1940 1928*)

Q Show that a country may have a gold standard though it has no gold in circulation and no great stock of gold. (*B Com 1942*)

By a gold standard we mean a currency the value of which is in some way or other linked up with the value of a given quantity of gold. The objects of the gold standard are, first to maintain stability of the exchange rates, and

Objects of the  
gold standard

secondly, to maintain stable prices. Gold, being a commodity having international acceptability and possessing a stable value, is regarded as a suitable metal for serving as the basis of currency.

The gold standard can take different forms and that is why we say that there are *degrees of the gold standard*.

The most well-known form is known as the *gold currency* or the *gold circulation standard*. In this, the link between money and gold is directly secured by making standard, freely minted coins containing a fixed weight of gold. This is the traditional form of the gold standard, and it was in existence in England throughout the 19th century.

It, however, came soon to be realised that it would be possible to have a gold standard without resorting to a gold currency. The essential objective is to secure a link between the value of money and the value of gold and this link can be secured by indirect means.

One method is to adopt what is known as the *gold exchange standard*. The internal currency may be made of silver and even of paper, and the link with gold may be secured by making this currency convertible into the currency of some gold standard country. In India, in the years preceding the War of 1914-18, the internal currency consisted of rupees, but these rupees were convertible into sterling at a fixed rate of 1s. 4d. for a rupee. As the sterling was based on gold, the link of the rupee with sterling linked it automatically with gold. This system naturally secures the main objective of a gold standard without entailing the necessity of issuing a gold currency.

Another variant of the gold stand is the *Gold Bullion Standard* which came to be adopted by a large number of countries after the War of 1914-18. Under it gold coins do not exist but the internal currency is made convertible into a fixed quantity of gold bullion. For internal purpose the paper notes will suffice. Gold bullion will be taken in exchange of notes only for the purpose of making payments abroad. The paper notes will represent a fixed quantity of gold and consequently the link with gold will be easily secured. As this gold bullion standard was adopted by almost all countries gold bullion became an international standard and this system has therefore sometimes been known as the *International Gold Standard*.

Besides these two other variations of the gold standard have recently made their appearance. One of them is the *Flexible Gold Standard* (adopted by the U S A) under which the currency authority can vary from time to time the quantity of bullion that a unit of internal currency would represent. And the other form is the *Gold Reserve Standard* under which there are agreements between countries to maintain gold reserves with a view to exchange equalisation through purchase and sale of bills of exchange.

Q 14 Discuss the merits and defects of the gold standard (B Com 1944)

The main advantages that are claimed for the gold standard (in any form) are three

First it is pointed out that the value of gold is compara

tively stable and, therefore, a currency linked to gold will easily maintain a stable level of prices *within* the country.

*Secondly*, it is held that gold is the international medium of exchange and through its movement from debtor countries to creditor countries, it will cause such price movements as to maintain international equilibrium. <sup>And</sup> if the currency of each country is linked to gold, the rates of exchange will remain steady.

*Thirdly*, the psychological value of having an objective standard is emphasized. People are not yet, it is held, advanced enough to understand a currency that is managed by a central authority with regard to factors not easily intelligible to the ordinary mind. But they can easily understand and respect a currency which is made up of or is freely convertible into what is commonly regarded as a sheet-anchor of stability and high value.

It was mainly because of these reasons that the gold standard was almost idolised. But recent experiences, during the last war and the last depression, have shown that the gold standard works smoothly only under certain conditions, and these conditions cannot be assured in the present day world.

For example, the successful operation of the gold standard is essentially dependent on every country playing what is called the "gold standard game". The first rule of this game is that a creditor country must freely receive gold and then expand currency and credit and that a debtor country must freely export gold and contract its currency and credit. Very few countries have in the recent past observed this rule and the gold standard cannot succeed unless this rule is strictly adhered to.

Then the maintenance of a gold standard compels the currency authority to pay more regard to external stability than to internal stability. This necessity of sacrificing internal stability for assuring stability in exchanges is very injurious to countries with a large volume of internal trade and a comparatively small volume of foreign trade.

The gold standard has up till now proved more or less a fairweather friend—working smoothly in undisturbed conditions but failing in every crisis. Besides, in recent years the value of gold had come to depend on American monetary policy converting every gold standard in a virtual dollar standard. The gold standard in its traditional form disappeared in the thirties and it is unlikely that it would be re-adopted except under radically altered conditions.

**Q 15** Distinguish between the mint price of gold and the market value of gold. Indicate the factors by which value of gold is determined (*B Com 1935* )

**Q** The influence of production of gold upon prices is greater than ever it was but it is indirect. Elucidate (*B Com, 1934* )

The mint price of gold is the rate at which gold can be had in exchange of internal currency at the Treasury, or more correctly, it is the amount of internal currency that is legally equivalent to a given weight of gold bullion. The mint rate is sought to be maintained by the authority by means of unrestricted purchase and sale of gold at the prescribed price.

The market price of gold is dependent on the actual

supply of gold in the market and the extent of the demand for it. This market price, it may be noted, is more dependent upon the total stock of gold than on the rate of production of gold.

Gold is a very durable commodity and hence the largest part of current supply consists of what was mined out in the past; the current production is only a small part of the current supply.

Hence, in the case of gold, value does not depend on the marginal cost of production; the value is determined by the total stock in relation to the total demand and the value that is actually established will determine the extent to which gold-mining can be carried on at present.

The market value and the mint value, however, have a tendency to equalise, and this tendency is made effective by the free purchase and sale of gold at the prescribed mint price by the Government or the currency authority.

Formerly, when gold was the only important medium of exchange, the influence of an increased production of gold on prices was direct. The owners of the newly-mined gold could command a larger purchasing power, and, consequently, they could contribute to raise the price level. At the present day, the direct influence, though not entirely non-existent, has ceased to be of importance. The proportion of payments in gold to total payments today is small, and new gold at the present day goes to banks and not to individuals.

The banks will, however, expand credit when they receive more gold in their hands. There will thus be an expansion

of paper currency and this will raise the prices. Formerly, increased supply of gold would have raised prices by increasing the quantity of gold coins. At the present day an increase in the supply of gold also raises prices but this it does by increasing the quantity of credit instruments in circulation. Gold today expands credit instead of expanding the volume of money proper.

Q 16 The break down of the international gold standard is a very serious hindrance to world commerce. Explain (B Com 1942)

The existence of a freely and properly operated international gold standard is a great stimulus to an expansion of international commerce. The international gold standard which existed in the late twenties was not however an ideal one. It was a gold standard circumscribed by the policies generated by the scarcity of gold in the debtor countries and by the sterilisation policy followed by the creditor countries. But so long as the gold standard was in existence exchanges were steady, remittance facilities were available and some help to the development of commerce was necessarily available.

With the suspension of the gold standard every country launched a defensive policy of isolation and restrictionism. As a result trade became smaller in volume and when recovery came it came not because the currencies had been managed properly but because of the normal recuperative power of the economic system.

There is no logical reason why a managed currency should not secure all the advantages of a gold standard. But in

practice, a gold standard involves a smaller volume of restrictions and obstacles than a managed paper currency and that is why the suspension of the gold standard means a hindrance to world commerce.

Q. 17. In what different ways is it possible to combine gold and silver in the currency system of a country ?

( B. A., 1934, 1931. )

The most important way of combining gold and silver in the currency of a country is to adopt bimetallicism. Under Bimetallicism it both the metals would concurrently circulate as freely-minted, full legal tender coins, and there would be a fixed mint ratio between the two metals. It would be possible to maintain bimetallicism if the currency authority would be prepared to change the mint ratio with every variation in the market ratio between the two metals. The failure to do this makes the double standard an illusion ; it becomes alternately a gold standard and a silver standard,

It has been proposed by Marshall and others that this difficulty may be obviated by introducing a joint standard instead of a double standard. The proposed Symmetrical standard, called symmetricalism, would involve the circulation of paper notes which would be convertible into both gold and silver jointly—one presenting a £ note at the Treasury would get half the value in gold and half in silver bullion. Thus people would have to offer gold and silver to get paper notes and to receive both gold and silver in exchange of paper notes.

Another method of combining gold and silver in a



currency system is the *Lumping Standard*, under which gold and silver are both made full legal tenders but while gold is freely minted, silver coins are issued in restricted quantities. The lumping standard is bimetalism with one of its legs broken.

It has been admitted by all economists that these methods introduce unnecessary complications. If gold and silver have at all to be put into circulation together, the best and the simplest method is to have a gold monometallic standard with silver token coins.

---

## CHAPTER VIII

### Banking and Credit

Q 1 Discuss the various functions performed by a modern bank ( *B A*, 1937, 1924, 1923, *B Com*, 1940, 1937, 1932, 1931 )

The main function of a modern bank is to act as an intermediary between the persons having surpluses and the persons wanting the use of these surpluses, i.e. between savers and the borrowers. It is impossible for the savers to seek out good fields of investment, and, consequently, they go to the banks to keep their money on deposit, these banks then advance loans out of the funds thus secured. When a bank accepts deposits it is borrowing, when it makes advances it is lending.

The two main functions of a modern bank are, therefore, the acceptance of deposits and the advancing of loans.

Types of deposits These deposits are accepted usually in three different forms. An individual with money to spare can keep his money on *fixed deposit* with the bank for a specified period and he will not usually be allowed to withdraw his deposit before the expiry of the specified period and he will be allowed interest at a comparatively high rate. He can also keep his money in *savings deposit* in which case he will generally be allowed to withdraw money only once a week. The most usual and useful form of deposit is, however, *Current deposit*, which allows withdrawal at any time the depositor wants. From the standpoint of the businessman the current account is a great advantage because it not only facilitates payments but also keeps record of all payments made and received.

On the other side a bank has to make advances out of the funds available. Loans are usually granted on the security of valuable property, but sometimes loans are also granted on the personal security of the borrower. The holder of a current account can get an *overdraft*, i. e. a permission to withdraw more than he has deposited.

When a bank lends, the borrower often does not withdraw the amount at once; he withdraws the amount gradually as necessities arise. The bank, therefore, enters the unwithdrawn amount in the deposit account of the borrower and in this way a bank is able to *create deposits* by granting loans.

These two functions are the most important of all functions performed by banks. "Modern deposit banking",

says Clay, "with its discount and cheque system is the highest product of utilisation of credit,"

**Loans through Discounting** The advances that are granted are often made by discounting promissory notes and titles to future payment. A businessman who will be in a position to pay in six months' time executes a promissory note and then gets an advance from the bank by discounting it. It is true therefore, to say that bank "exchanges its own credit for its customer's credit."

Besides these there are, of course, other functions of a modern bank. **Note issue** is often undertaken by banks, though the present day tendency is towards concentrating the power of issuing notes in the hands of the Central Bank. Besides a bank facilitates remittance through drafts, makes travelling easy through travellers' cheques and letters of credit, arranges for safe custody of valuable things, facilitates international trade by buying and selling bills of exchange, keeps records of the customer's payments and receipts and performs a number of other similar services.

**Q 2** Mention some credit instruments. Show how they economise the use of gold and how they can be used as media of exchange. (*B A, 1941, 1939, B Com, 1932, 1929, 1928*)

**Q** What are credit instruments? Discuss their utility. (*B A, 1945*)

**Q** What is credit? (*B A, 1944*)

By credit we mean the power of commanding at present what one normally would be able to command in future. If a businessman expects that three months hence he would be able to make some money, he may borrow and spend now and then pay off the debt.

**Meaning of credit**

when money has actually come into his hand. Here what he has done has been to transfer to him now the purchasing power that would otherwise have been available to him three months later.

There are different sorts of credit instruments. Anything that is taken on trust, or on confidence in the solvency of the person offering it, is a credit instrument. The two most important instruments of credit are *cheque* and *bills of exchange*. A *cheque* is an order upon a bank

Cheques and bills of exchange to pay a specified amount out of the deposits of the drawer to the person named. A cheque may be drawn upon deposits lodged by the depositor out of his personal income or upon deposit created by the bank through the grant of a loan. So long as people have confidence in the drawer and on the drawee, cheques will circulate from hand to hand. Cheques economise cash not only because large amounts can be paid through these instruments but also because cheques on different banks often cancel one another, making cash payment unnecessary.

A *bill of exchange* is an order upon a person (usually a buyer or an importer of goods) to pay at the end of a prescribed period of time (usually, 30, 60 or 90 days). The bill of exchange becomes a credit instrument when the drawee or his representative has accepted it. It is worth the specified amount of money at the end of the period of maturity and it can be used as a medium of payment. The drawer of the bill of exchange does not generally wait till the end of the period of maturity; he 'discounts' the bill at some bank which pays him the specified amount minus a discount at the current rate of interest on short-term loans. So long as people have confidence in the persons and the

parties, a cheque or a bill of exchange will easily pass from one hand to another and will thus serve as a medium of exchange making possible a considerable economy of gold

There are of course other forms of credit instruments. As we have already noted anything accepted on trust is an instrument of credit, and in this sense Bank notes, drafts, bond etc. a bank note that is not fully backed by reserves, a currency note issued by government, a banker's draft, promissory note, a bond are all instruments of credit. Bank notes and government notes are a very important part of the circulating media and as these are not usually fully backed by legal tender reserve they circulate on the strength of the credit they command. All these can serve one or more functions of money to a certain extent and all these therefore bring economy in the use of gold.

The most important utility of credit however, is that it enables a producer or a trader to get a present command over his future income. A businessman has to spend first and earn later and the means for spending are available to him through credit instruments. If he can satisfy a bank that his income prospects are certain the bank will readily make purchasing power available to him. Besides credit instruments today form such a large part of the circulating media that a central bank can control prices through changes in the terms and volume of credit.

Q 3 Both notes and cheques form part of our currency. There are differences however. Discuss (B Com 1943)

Notes and cheques are both credit instruments and as such produce similar effects on the economic system. But

there are important differences between these two types of credit instruments.

First, notes are generally legal tender, while cheques never are. Notes are issued either by the government or by the Central Bank, while cheques are drawn by private individuals.

Secondly, notes are issued according to law or convention at the initiative of the note-issuing authority. Cheques are issued by private individuals against their deposits. These deposits are either lodged by them in the banks out of their own savings or created by the banks in favour of borrowers.

Thirdly, in every country there are statutory provisions regarding the distribution of assets held against notes. But the distribution of assets held against deposits withdrawable by cheques, while controlled by law in countries like the U.S.A., is left at the discretion of bankers in Great Britain.

Lastly, notes easily pass from hand to hand and are rarely presented for encashment. Cheques also pass from hand to hand, but within a short time they are either cashed at the drawee bank or cancelled through the clearing house.

There are, besides, some technical differences. Notes are issued in certain specified denominations only. Cheques can be issued for any amount, large or small, including fractions of the standard money unit. Payment by cheque secures a record of the transaction made, through the counterfoil of the deposit holder and through the books of the drawee bank. A cheque, if crossed properly, is secure against theft and misappropriation.

Q 4 Credit is capital" "Credit is not Capital"

Discuss ( *B Com.*, 1930 *B A.*, 1923 )

By granting credit a bank enables a businessman to get command over materials and resources, i.e. to get all the advantages that possession of capital would give To a businessman the getting of credit and the getting of capital are practically of the same significance

But it should be noted that credit in itself does not bring capital into being nor does it increase the fund of society's capital Tools, machinery, building materials raw materials, etc are created by labour, and not by lending as such But a bank, though not creating capital, is instrumental in regulating the command of capital and in promoting the effective use of capital Credit represents titles to capital and it transfers the command over capital from those who possess it but cannot utilise it to those who do not possess it but can utilise it

Credit is not capital

Credit gives command over capital

Q 5 Explain the process by which banks create credit. What are the limitations on the power of the banks to create credit? ( *B Com* 1938 1934 1931, 1928 1927, *B A* 1932, 1927 )

Q Explain 'Loans create deposits and also Bank deposits have in modern times changed from deposits of cash to deposits of credit' ( *B A* 1930 1927 )

Q. Banks can only lend what the depositors have entrusted to them Examine this view of the origin of bank loans ( *B Com.*, 1945 )

A bank normally accepts deposits from genuine savers and lends the funds thus secured to businessmen. Such deposits represent community's saving and the bank *passively* receives these; these can be called "*lodged deposits*."

A bank, however, can also *actively create deposits* in favour of borrowers who have offered good security and arranged for a loan but have not withdrawn the amount borrowed. When a bank has received a genuine savings deposit of Rs. 500, it can keep Rs. 100 in reserve, and arrange to lend out the remaining Rs. 400. If, however, the person who borrows this amount does not withdraw it at once, a deposit will be created in his favour, and the total deposit figures of the bank will swell to Rs. 900.

If the borrower wants to withdraw the amount borrowed by him he will draw cheques. Most of these cheques will be deposited in some bank or other and in this way the lending power of the banking system as a whole will increase.

Banks are thus able to manufacture credit. "They accept deposits which they loan out again, and, in addition, make advances which have no deposits against them, by creating claims on themselves."

There are, however, limits to this power that banks have of manufacturing credit. The extreme limit is set by the extent of the valuable security that can be offered by the borrowers. This limit, however, is very far off, and the *real limit* is imposed by the necessity of keeping a cash reserve.



Most of the claims against banks are set off against one another, but some cash is necessary for paying those who may require it. A large cash reserve would secure safety, but to that extent reduce profits, while a small reserve would increase profits at the cost of safety. A banker has, therefore, to keep a safe proportion of reserve, and if expansion of credit tends to lower the reserve below this safe proportion, he has to stop.

Practical bankers generally hold that banks can only lend what the depositors have entrusted to them; they argue that the initiative in the matter of expansion of credit rests not with banks but with depositors. From what we have seen above about banks' power of creating deposits, it is difficult to accept the thesis put forward by bankers. Keynes points out that if the Central Bank is willing to offer accommodation to the member banks, the member banks can go on expanding credit almost to any extent. The Central Bank, says he, conducts the orchestra and sets the tempo. A practical banker, however, knows that the Central Bank may not always fall in with the wishes of the member bank and hence he is always alert for protecting his reserve.

Q 6 Distinguish between bank credit and commercial credit (B A 1944)

By bank credit we mean anything that a bank does to make a transaction possible without the immediate use of actual cash. We get examples of bank credit in created deposits in bank drafts, letters of credit and cheques.

Commercial credit is created by merchants and traders. The best example is a bill of exchange through which the

seller gives credit to the buyer and at the same time assures himself of payment. Book credits are also examples of commercial credit. There is some transaction in goods behind every commercial credit but not necessarily behind all cases of bank credit.

Q. 7. What is the influence of credit on prices? (*B. Com.*, 1936; *B. A.*, 1938, 1932, 1929.)

It has been held by some that credit will have no influence on prices because the instruments of credit cancel one another. This view is evidently erroneous. Continuity of credit All credit instruments have ultimately to be liquidated in cash according to law, but in practice a credit instrument is often paid off by another credit instrument, and in this way a continuous fund of credit is maintained.

Whatever may be the true legal nature of credit, it is apparent that credit expands purchasing power, and, consequently, credit can have as much influence on price as money proper. If, of course, a certain amount of cash has to be held in reserve against the credit issued, there is small diminution in the purchasing power available in the form of money, but this is negligible when compared with the volume of purchasing power available in the form of credit instruments. The credit instruments, therefore, are like money in influencing prices, and prices rise when the volume of credit expands, or when the velocity of circulation of credit instruments increases, or when both of these are present simultaneously.

Q. 8. "The art of banking lies in being able to distinguish between a bill of exchange and a mortgage". Explain

this statement and illustrate your answer with reference to the operation of Commercial Banks in Great Britain

(B Com, 1944)

Ordinary commercial banks generally accept deposits for short periods. Current account or demand deposits can be withdrawn by the depositors at any time savings bank deposits generally once a week and time deposits at intervals of not generally more than a year. As these deposits are short term liabilities for the banks they in their turn cannot lend for periods longer than a year, and naturally they would prefer investments which mature within two or three months. A commercial bank in Great Britain therefore, will lend readily on the strength of Treasury bills or first class bills of exchange and will freely purchase these. A treasury bill is a promise by the government to repay at the end of two or three months. a bill of exchange is a buyers promise to pay after 30, 60 or 90 days. Commercial banks find in these good instruments for investing their funds so that these may earn something without sacrificing liquidity to any dangerous extent. Treasury bills can be easily re sold in the market and bills of exchange rediscounted. Hence these are the most important items in the schedule of the assets of a British Commercial Bank.

On the other hand, a mortgage involves a valuable and durable property used as a backing for a long term loan. A commercial bank operating with money borrowed short" cannot lend long. A mortgage means locking up of working capital for a long time and besides the value of the asset can fluctuate to a large extent. A mortgage asset cannot be readily sold in the market and consequently it is a bad asset for a bank that wants to maintain its position liquid. Special

types of banks working with debenture-funds or long term deposits can, of course, deal in mortgage credit. But commercial banks have to draw a clear line of distinction between short-dated assets like the bills of exchange and mortgage-assets. They can deal only in the market for short term deposits and short term loans.

Q. 9. What considerations influence the banker in determining the character, composition and the amount of his reserve? (*B. Com., 1933.*)

Q. Indicate the objects for which bank reserves are held. Discuss the merits of the various ways by which the banks of different countries protect their reserves. (*B. A., 1933.*)

Every bank has to maintain a reserve for meeting the demand for cash. The depositors, payees of cheques, persons wanting to discount bills of exchange may all require cash, and, therefore, every bank has to keep its assets in such a manner as to be able to meet any demand upon it. The safest course would be to keep the entire assets in a perfectly liquid form, *i.e.* in cash, but this would mean that the bank would earn no profit. For earning profits the bank must sacrifice the liquidity of assets; for securing safety some liquidity must be maintained.

A banker, therefore, has to strike balance between the two. Some part of his assets he keeps in a perfectly liquid form, *i.e.* in cash. What part is to be kept in cash would depend on banking traditions in a particular country; in England banks usually keep in cash about 9 per cent on their total liabilities.

The other assets are kept in a non-liquid form, but even in respect of these, the banker will try to secure liquidity if necessary. A banker, for example, can invest in industrial loans and also in Government paper or treasury bills. A loan granted to an industry means the freezing of the asset for a definite period, but an investment in Government paper secures some liquidity, because if the banker will ever have to face an emergency, the papers would be readily sold and cash would thus be secured. Cash can also be readily secured by rediscounting bills of exchange.

The reserves of a bank consist of cash, bullion, semi-liquid assets and assets of different degrees of 'illiquidity'. The composition of the reserves would depend upon the character of the business done, the scope of investment and also upon the nature of the help the bank can expect from the Central Bank. In a country where there is a good Central Bank, member banks can be sure of getting assistance in emergency, and there will not, therefore, be any necessity of maintaining a large cash reserve.

Ordinarily by the term *reserve*, only the cash reserve is meant. Every bank has to protect this cash reserve, and there are, in general, two methods of doing so, namely, manipulation of the interest rate and open market operations. When the cash reserve is falling, a bank may raise the rate of interest, this will attract deposits and discourage discounting of bills—leading to an increase in the amount of cash in the hands of the bank. By open market operations we mean purchase and

Protection of the  
cash reserve

Discount rate

sale of investment-securities in the open market. When the cash reserve of a bank is falling, it may sell in the open market securities held by it, and in this way augment its fund of cash. What actually happens in this case is that non-liquid reserve is converted into a liquid reserve. Generally these two methods are adopted, not by the banks individually, but by the Central Bank.

Q. 10. Draw an imaginary balance sheet of a commercial bank and explain the items mentioned therein. (*B. Com., 1942.*)

A commercial bank creates liabilities against itself whenever it accepts a deposit from a customer or creates a deposit in his favour. On the liabilities side, therefore, will appear in addition to its own share capital, the deposits in favour of the customers. On the assets side will appear everything held by the bank—cash and everything that represents or can be turned into cash. The liabilities and assets have, of course, to balance and a proper apportionment has to be made between the different types of assets held.

The following imaginary balance sheet will be helpful in explaining what has been said above :

### XYZ Bank Ltd.

| <i>Liabilities</i>  | <i>Assets</i>   |
|---|---|
| (a) Capital and Reserves...Rs. 5,00,000                   | (d) Cash in hand...Rs. 2,00,000                           |
| (b) Deposits ...Rs. 15,00,000                             | (e) Cash in other banks ...Rs. 2,50,000                   |
| (c) Minor liabilities Rs. 50,000<br>(details to be given) | (f) Cheques in course of collection, etc. ...Rs. 1,25,000 |

|              |   |
|--------------|---|
|              | (g) Money at call and<br>short notice . Rs 4,00,000 |
|              | (h) Bills discounted<br>.. Rs. 1,00,000             |
|              | (s) Investments Rs 5,75,000                         |
|              | (j) Advances . Rs. 3,50 000                         |
|              | (k) Other items . Rs 50,000                         |
| <hr/>        | <hr/>   |
| Rs 20,50,000 | Rs 20,50,000  |

(a) This item includes the paid up capital supplied by shareholders and the reserves created out of net profits.

(b) Deposits include time deposits and demand deposits and usually detailed figures are given of different categories

(c) This item may include notes issued, if any, special funds created, etc

(d) A convenient amount of cash has to be kept for meeting the daily demand of the clients

(e) Cash in other banks, especially the central bank is as good as cash in hand, because this can be immediately drawn upon in case of necessity and can be used for meeting inter-bank obligations

(f) Cheques are constantly coming in and sent out. Some remain uncashed at any particular moment and these represent an asset, of course, on the assumption that they will be cashed

(g) This item represents very short term loans granted to bill brokers and others on condition that there will have to be repaid on demand

(h) This item includes the bills of exchanges purchased and discounted by the bank

(i) Investments represent long term securities held by the bank, and

(j) Advances indicate the loans granted—in Britain usually through overdraft facilities—to businessmen. Minor items are included in the last figure.

The assets are arranged above in a descending order from the standpoint of liquidity and in an ascending order from the standpoint of earning power. Cash in hand has the maximum liquidity, but earns nothing, while advances represent temporary freezing of cash, but enable the bank to earn between 5 or 6 per cent. In Britain the cash generally is 10% or 9% of the total assets, while cash call loans and bills together constitute about 33½%.

Q. 11. What is the function of the Central Bank in the currency system of a country ? (*B. Com.*, 1940 ; *B. A.*, 1938.)

The banking system of a country is an organic whole ; different parts of it are essentially linked up with one another and it is impossible for one bank to move in a particular direction without causing some effect on the other banks. It is because of this that it is essential that there should be in every country a Central Bank for directing

and guiding the entire banking system. The Central Bank may be an institution entirely run by the Government or it may be a State-regulated shareholders' bank ; but, in any case, it is the pivot of the banking system and what the banking system as a whole does is what it is led to do by the Central Bank.

The Central Bank is, first, the *bankers' bank*, i.e. an institution that keeps the reserves of the member banks, and if necessary, grants loans to them. As all banks keep their reserves with the



Central Bank, it becomes the depository of the entire banking reserves of the nation and the duty of maintaining this reserve (by the manipulation of the *bank-rate* and by *open market operations*) devolves upon it. The Central Bank can in this way encourage or discourage credit expansion, if it is prepared to grant accommodation to member banks, these can go on expanding credit. The Central Bank, says Keynes, is the conductor of the orchestra and it sets the tempo. It also offers facilities for re discounting bills of exchange.

Another important function of the Central Bank is the *issue of paper currency*. In most countries the Central Bank enjoys this power as a monopoly right, and exercises it according to the law or the traditions. Its position as the bankers' bank gives it control over credit and its position as the note-issuing authority gives it control over currency. Thus, having the power to control both currency and credit, the Central Bank naturally becomes the pivot of the economic structure.

The Central Bank is also the banker to the Government. It receives and makes all payments on behalf of the Government and also manages the public debt.

As the controller of credit and currency, as banker of the Government, as the authority determining the rate of interest, as the ultimate holder of foreign resources, the Central Bank plays an important part in the economic life of a country. By its own policy it can to a

large extent, influence the growth of trade and commerce in a country.

[ There are, in general, two types of Central Banks—*centralised* and *decentralised*. The Bank of England, as regulated by the Bank Charter Act of 1844 is a centralised institution, it being the single body controlling currency and credit. The Reserve Bank of India is also a centralised banking institution. In the U. S. A., however, central banking is decentralised.

The Bank of England and the Federal reserve system

There are twelve Federal Reserve Banks controlled by a Board of Governors ; each Federal Reserve Bank is the Central Bank for the area allotted to it. ]

✓Q. 12. What is bank rate ? Discuss the effects of the bank rate on general prices and on trade and industry. ( *B. Com.*, 1939 ; *B. A.*, 1939, 1931, 1924. )

The bank rate is the official rate at which the Central Bank is prepared to discount bills of exchange. It is generally higher than the rate of discount prevalent in the market ; banks discount the bills at a low rate, and if necessary, rediscount them at the Central Bank.

This bank rate or the official rate of discount has an important effect on prices. The effect is produced in three different ways—through the influence (i) on the quantity of bills discounted, (ii) on gold reserves, and (iii) on the relation between saving and investment.

A rise in the bank rate will reduce the number of bills discounted ; holders of bills will find it profitable to hold the bills till maturity rather than to cash these at a high discount. The result will be a diminution in the quantity of bank money flowing into the hands of the public.

Effect on the number of bills discounted

A fall in the bank rate on the other side will increase the number of bills discounted and thus increase the flow of bank money in the hands of the people. A rise in the bank rate has thus a deflationary effect, and a fall in the bank rate an inflationary effect.

The second effect of the bank rate comes through the bank reserves and short loan funds of foreign investors. If the bank rate rises, foreigners will send funds to be invested at high rates, and thus bank reserves will increase enabling them to expand credit. If the bank rate falls foreigners will withdraw their balances, the reserves will thus fall, and credit will have to be contracted. The effect here is the opposite of that mentioned first, the two may almost neutralise each other.

The most important effect of the bank rate on prices and on trade and industry comes through the influence on saving and investment. A high bank rate will encourage saving and thus reduce the expenditure on current consumption. It will, on the other side, make it unprofitable for business men to borrow, as a result business investments will decline and labourers and raw material producers will earn less. Their purchasing power will decline. The combined result of all this will be to cause a downward movement in trade and industry and a fall in prices. A lowering of the bank rate on the other hand, will discourage saving increase expenditure on current consumption stimulate business and increase all incomes. Trade and industry, therefore, will flourish and prices will rise.

The bank rate is therefore, an effective regulator of the

economic system, except in very special cases. When a boom is in sight a raising of the bank rate will put a brake on the expanding tendency : and when a depression is apprehended, it can be prevented by a lowering of the bank rate of discount.

**Q. 13.** Discuss the various factors that influence the discount rate. What is the relation between the discount rate and the general rate of interest ? ( *B. A., 1933.* )

The discount rate depends fundamentally on the supply of bills of exchange and the demand for getting these discounted. If the market conditions induce people to hold cash, the demand for discounting of bills will be greater, and banks will then be in a position to charge a high rate of discount. When people are unwilling to hold cash, banks will be compelled to lower the rate of discount.

The rate of discount also depends on the rate of return available from other channels of investment, *e. g.* from a new issue of Government loans. If the Government is borrowing at a high rate, all holders of bills will cash their holdings and invest in Government paper. The rate of discount in such a case will rise. And, when no good investment is possible, people will go on holding their bills, and, consequently, the rate of discount will have to fall. Every change in the assets available in the money market, *e. g.* a new issue of treasury bills, will affect the rate of discount for bills of exchange.

Speculation also plays some part. There are often specu-

relative transactions in bills of exchange themselves, and, besides, bills may be discounted in large numbers in order to provide funds for speculative transactions in other commodities.

The discount rate is the rate of interest for the short term loans while the general rate of interest is the rate for long term loans. There may be some disparity between the two, because some funds may be available only in the short-loan market and not in the long term loan market. But, in the main, the two rates would move on parallel lines, because a great disparity between the two may mean transfer of funds from one market to the other. A high discount rate in the short loan market may induce holders of long term securities to sell their assets and to invest the money thus secured for short periods. And the reverse of this is also quite probable.

/ Q 14. Describe a Clearing House, and the economic service it renders. (*B Com., 1941, 1935*)

A Clearing House is a place where agents of different banks meet for settling claims against one another. Every day, every bank receives claims against other banks and from other banks. These may, to a large extent, be cancelled against one another, and it is for facilitating such cancellation and settlement that Clearing Houses are established.

All members of the Clearing House have an account with the Central Bank of the area and the Central Bank also keeps an "Account of the Clearing Bankers." At the close of the day's business, the balance due to or from the

Clearing House from individual banks is ascertained and the amount is transferred to or from the Account of the Clearing Bankers from or to the account of the individual banks.

*The Clearing House is able to save much trouble, time and expense. Every bank receives cheques on other banks.*

*If every bank has to send its messengers Services rendered to other banks for encashment of the cheques received, there will take place every day a large number of payments and cross payments which can easily be avoided by the Clearing House. All cheques received by one bank against the others are taken to the Clearing House, where all claims and counter claims of one bank vis-a-vis another are checked, and only the net excess of claims has to be paid. Even this is not paid in cash ; the excess is paid by transferring the sum from the account of one bank to that of another at the Central Bank.*

Q. 15. What are cyclical fluctuations ? Discuss their causes. Mention some measures that have been suggested for the effective control of these fluctuations. ( *B. A., 1943.* )

Q. Discuss the theories that have been put forward to explain the cyclical nature of trade fluctuations. ( *B. Com., 1935, 1931.* )

Q. What are the causes of industrial or economic crises ? How can these be prevented ? ( *B. A., 1938, 1934.* )

A study of the history of economic development shows that progress has never been smooth and continuous.

Ups and downs There are alternating phases of ups and downs, of good employment and unemployment, of increased activities and depression, of high prices

and low prices. It has been our experience that trade and industrial fluctuations are cyclical in nature. A period of optimism, of increased activities, credit expansion, high prices and profits is followed by one of stagnation and pessimism, of low prices, low profits and a low level of employment. To this entire movement or fluctuation we give the name of a *trade cycle* and we use the term *crisis* to denote the sudden change from a rising phase to a downward phase.

Various explanations have been given to account for these cyclical fluctuations or the recurrence of industrial crisis. Some have tried to explain these *Over production* by pointing out that production often increases beyond what can be purchased at remunerative prices by the consumers. Where producers find that they have produced so much that they are not able to sell their output at a profit, they suddenly contract production, producing a series of repercussions on every part of the economic structure.

Others point out that the main cause of a boom or rapidly rising activity is indiscriminate credit expansion. If credit gradually goes on expanding, a *Credit expansion* stage will come when bank reserves would become inadequate. Some banks will fail and others will contract credit. In any case, a panic will ensue and this will bring about a crisis.

There are others who point out that the main explanation of the trade cycle is to be found in psychological factors. *Psychological factors* Optimism breeds further optimism and the upward phase continues. Then suddenly some external cause gives a shock to this

optimism and it suddenly turns itself into a pessimism of the worst sort—causing a stagnation in trade and industry.

We have to remember that a trade cycle is a complex result of many factors and it is impossible to find one single explanation of its recurrence. The causes of trade cycle are partly *industrial*, partly *monetary* and partly *psychological*, and if remedies are to be sought they also can be applied in these three different directions.

By restricting output before a crisis has actually come or by making the wages elastic it may be possible to tackle the industrial causes of the trade cycle. A good Central Bank, or a watchful Government may put a check on undue expansion of credit. And the waves of undue optimism and pessimism can be regulated by making information about actual conditions in the market more widespread and by giving full publicity to the shape things are coming to take.

As effective remedies, there are two important policies.

|                                 |  |
|---------------------------------|--|
| Regulation of the interest rate | The first is the regulation of the <i>rate of interest</i> . An increase in the rate when prices are on the upswing and a reduction of the rate when a depression is near at hand would help to stabilise the prices, activities and production.   |
| Public works policy             | The second is a wisely directed <i>public works policy</i> . If during a depression the Government would undertake a sound scheme of public works, the labourers will get employment and increased purchasing power; and this may compensate for the reduction in business activities undertaken by private entrepreneurs. |



## CHAPTER IX

### International Trade and Foreign Exchange

Q 1 Estimate the advantages of international trade  
( *B Com, 1930, B A, 1921* )

Q Discuss the advantages and disadvantages of  
international division of labour ( *B A, 1921* )

Trade between nations is only a special case of localisation of industry or territorial division of labour. All places are not equally efficient in the production of all commodities, some have physical, climatic and economic advantages for the production of particular commodities while others may have advantages in other directions. Every country gains if it imports things it cannot produce efficiently and exports things in the production of which it is particularly efficient.

The greatest advantages of international trade or international division of labour is that every country is able on the one side to get things it cannot produce with efficiency, and on the other, to apply all its labour and capital for the production of those commodities which it can turn out best. Every country, therefore gains as a consumer—because it gets at the cheapest possible price things produced under the best possible circumstances and as a producer because it is able to secure the most productive use of its own resources.

International division of labour thus leads every country to apply its resources in the most productive manner and on the whole, therefore, the total resources of the world are most fully utilised. And, moreover, the mere fact of international trade or the production by every country of the things it can produce best leads to the creation of new economies and as a result everyone is able to get the advantage of lower prices.

The final result of this is the creation of a link of interdependence between all countries. This converts the whole world into one economic unit of which every part serves the others in the best possible manner. Trade and communications develop hand in hand, and the effect of this economic interdependence is to bring about some degree of political amity among nations.

Sometimes, however, this international trade makes for difficulties and hardships. When trade goes on freely between an industrially developed country and other that is backward in development, the latter will not be able to make her industries efficient. It is because of this difficulty that unrestricted foreign trade has often to be checked by means of protective duties. International trade may also lead to exploitation of resources at the present moment at the cost of the interests of the future generations. Besides, too great an interdependence among nations will lead to difficulties when communications and trade are cut off by, say, a war. It is because of this danger that a plea is often put forward for a *diversification of industries*.

In spite of all these disadvantages it remains true that the advantages of international trade cannot be forgone by any country today. The disadvantages can, to some extent, be neutralised by protective tariffs, planned exploitation of resources and deliberate attempt at diversification of industries

Q 2 Why is it necessary to formulate the theory of international trade as distinct from that of domestic trade ?  
( B Com., 1933 )

Q Discuss the basis of international trade. ( B A., 1943, B Com., 1944 )

The theory of value is pre-eminently an analysis of the relation between supply and demand, and this analysis should naturally be as true in the case of international trade as in that of domestic trade. If, therefore, we formulate a separate theory of international trade the reason lies in the differences in the conditions attendant. In the case of trade between nations a number of obstacles or difficulties have to be overcome. Long distances have to be covered and heavy transport costs incurred. Customs duties have to be paid on crossing every frontier. Differences in language, laws, business practice and currency system—all these also account for the special character of the theory of international trade.

The most important cause of this special character is, however, found in the comparative immobility of labour and capital between one country and another. If all resources had been capable of moving freely from one country to another there would have been little or no comparative

difference in costs, and international trade would have been unnecessary. But, resources, in fact, do not move freely from one region to another, and consequently, one area produces a commodity cheaply while another area is efficient in producing another commodity. International trade in goods, points out Bertil Ohlin, is the inevitable result of international immobility of resources, and it is this immobility that is the main factor in giving to the theory of international trade its special character.

Q. 3. State and explain the law of comparative cost as applied to foreign trade. ( *B. Com., 1938, 1925.* )

Q. State and examine the theory of international values. ( *B. A., 1938, 1925.* )

The special character of the theory of international values arises from differences in the relative scarcities of factors of production in different countries and from the immobility of these factors. As a result, one country may produce wool at a low cost while another may be able to turn out motor cars very cheaply. In such cases of *absolute differences* in cost, trade would quite naturally be established between the wool-producing country and the motor car producing one.

In most cases, however, trade takes place because of differences in comparative costs. We may take two countries A and B, each capable of producing wool and jute. Suppose country A can produce at the cost of Rs. 10 either 10 mds. of jute or 15 mds. of wool. In country A, therefore, the rate of exchange between jute and wool will be 1 md. of jute =  $1\frac{1}{2}$  md. of wool. And, suppose, in country B, at the same

Absolute differences in cost

Comparative differences in cost

cost it is possible to produce 8 mds of jute or 10 mds of wool, the rate of exchange being 1 md. of jute =  $1\frac{1}{2}$  md. of wool

Here, apparently, country A is more efficient than country B in producing both jute and wool. But, *comparatively*, her efficiency is greater in the case of wool than in producing jute, she has advantage in both, but a *superior advantage* in wool. On the other side,

country B is less efficient than A in the production of either of the commodities, but she has a *smaller disadvantage* in

producing jute than in producing wool. Country A will gain by producing wool only because her efficiency in producing it is comparatively great, country B will gain by producing jute because her comparative inefficiency in producing jute is small. Trade will take place between A and B, A producing wool only and getting her jute from B.

This is a simple statement of the theory of comparative advantage or comparative cost. Every country produces the commodity in which she has got a superior comparative advantage, or, if that is not possible, the smallest comparative disadvantage.

The actual rate of exchange between A's wool and B's Jute will depend partly upon supply conditions and partly upon the conditions of demand. A will be quite willing to take B's jute, provided she has to give less than  $1\frac{1}{2}$  md. of

wool for every maund of jute, if she has to pay more it will be profitable for her to produce jute herself. Similarly, B will be quite willing to buy A's wool, provided she receives more

The actual rate  
of exchange

than  $1\frac{1}{2}$  md. of wool for 1 md. of jute. The rate of exchange between jute and wool will, therefore, lie —lies between limits set by comparative costs— between the limits set by the two comparative cost ratios in the two different countries, i.e. between 1 md. of jute =  $1\frac{1}{2}$  md. of wool and 1 md. of jute = 1 md. of wool. Any rate midway between these two will satisfy both A and B.

Where the actual rate will lie will depend on the intensity of A's demand for B's jute and the intensity of B's demand for A's wool. In every bargain, — and is determined by reciprocal demand the purchaser with a greater degree of eagerness loses, and hence the rate will be favourable to the country having an elastic demand for the other country's goods and unfavourable to the country whose demand for foreign goods is inelastic.

We can, therefore, conclude that the values of commodities entering international trade between two countries will be determined by the reciprocal intensity of demand acting within the limits set by comparative costs.

Q. 4. Suppose that the same cost produces 10 units of wheat or 15 units of sugar in the country A and 15 units of wheat or 10 units of sugar in the country B. Is trade likely between A and B? (*B. A., 1911.*)

This is a clear case of advantageous international trade. Country A is relatively more efficient in producing sugar and country B in wheat. Country A will gain if she devotes all her resources to the production of sugar and gets wheat by exchange from B. The amount of expenditure which can

produce 10 units of wheat in A will produce 15 units of sugar. If this amount of sugar is sent to B, B can give up to  $22\frac{1}{2}$  units of wheat in exchange for, in B, 10 units of sugar have the same cost as 15 units of wheat. Similarly B will gain by producing wheat alone and securing sugar by exchange from A.

Any rate of exchange between 1 unit of wheat =  $1\frac{1}{2}$  units of sugar (the cost ratio in A) and 1 unit of wheat =  $\frac{2}{3}$  unit of sugar (the cost ratio in B) will be profitable to both the countries.

Q 5 Why does not each country concentrate on the production of one article only and secure all the other goods it needs by exchange? (*B A, 1913. B Com 1911*)

According to the strict theory of international trade each country should produce that article only in the production of which it has the largest comparative advantage, and secure all its other requirements by exchange. But in practice, it is not possible for any country to follow this rule. There are many reasons for this. First the resources available within the country may be inadequate for producing such a large output of the selected commodity as to make possible the import of all other articles in exchange of it. Secondly, there may be perishable and bulky resources available within the country which would run to waste if they are not utilised to produce something even if comparative advantages are not great. Thirdly too large an expansion of the production of one article only may bring in the operation of the law of diminishing returns thus turning the comparative advantage into a disadvantage. Lastly, too much dependence on the production of one article only will

mean great distress and unemployment if suddenly there is a shift in the demand in the world market to the output of some other country or to some newly invented substitute. It is because of these reasons that, in practical policy, diversification of industries, even at some sacrifice, has been held to be preferable in the long run to the development of one single industry.

Q. 6. "The fact that a commodity can be produced at a lower cost by one country than by another is no guarantee that it will pay the first country to produce it and not import it from the second." Explain and illustrate this statement. (*B. Com., 1945.*)

International trade depends not simply on cheapness of the cost of production, but on *comparative* cheapness of cost. England may produce wheat more cheaply than Canada; but it does not necessarily follow that England will produce and export wheat. If England's comparative efficiency is greater still in producing barley, it will pay her to withdraw her resources from the production of wheat and concentrate them in the production of barley. A very large output of barley will make it possible for her to get more Canadian wheat than she could obtain if she had used some of her resources for producing wheat in preference to barley.

A concrete case may be taken. Suppose a given cost produces in England either 10 bushels of wheat or 12 bushels of barley; the very same cost produces in Canada 5 bushels of wheat or 3 bushels of barley. Here England's cost of production of wheat is lower than Canada's. But it will be profitable for England to produce barley and get Canadian wheat through exchange, because while her pro-



duction is efficient in growing wheat, it is still more efficient in growing barley 12 bushels of barley sent to Canada will fetch in exchange 20 bushels of wheat (because in Canada 5 bushels of wheat and 3 bushels of barley have the same cost of production) But if England had devoted the given amount of expenditure to production of wheat on her own soil, she would have got 10 bushels only

Q 7 Our imports are paid for by our exports"  
Elucidate ( *B A* , 1941, 1936, 1934, 1932 1931 , *B Com.*, 1938 )

Q How is the balance of indebtedness between two countries settled in normal times ? ( *B A* , 1919 )

Q 'The flow of specie from one country to another sets in motion forces which sooner or later stop the flow'  
Amplify ( *B A* , 1926 )

The balance of indebtedness between two countries depends not only on the export and import of goods but also on the export and import of invisible services A country receives payment from abroad for the goods it exports, it also receives payment for the services it does to people in other countries Payments, therefore are received for both visible and invisible exports, and payments have similarly to be made for both visible and invisible imports

Visible and In-  
visible items  
of trade

Among items of invisible exports and imports we may mention shipping banking and insurance services rendered by one country to another, tourists expenses payments of loaned funds repayment of loans payments of interest, educational expenses abroad, etc

The indebtedness of a country to another normally balances with what the country is to receive from the other country. This we generally put in the form of the statement that *exports pay for imports* or that exports and imports balance each other. Of course, Exports pay for Imports when we make a statement like those given above, we mean that visible and invisible exports taken together pay for the sum of the visible and the invisible imports.

That in every case an ultimate equality between exports and imports will be reached can be easily shown. If in the trade between country A and country B, country A has a favourable balance of trade or an excess of exports and country B has an unfavourable balance of trade or an excess of imports, country B will have to pay country A for the excess, and this payment can only be made in gold. Gold will, therefore, flow out from country B to country A, lowering the volume of money and bank reserves in the former and increasing the volume of money and the bank reserves in the latter. As a result there will be deflation and low prices in country B and inflation and high prices in country A.

The inevitable result of this will be to discourage exports from A and imports into B and to encourage exports from B and imports into A, because a country with high prices is a bad one to buy from, while a country with low prices is a good one to sell in. Exports from A to B and those from B to A will thus come to equality as the result

of the price changes brought about by the flow of specie. The flow of specie itself will make the flow of specie unnecessary.

There cannot remain, therefore, any disparity in the long run between a country's exports and imports. If exports

exceed imports, gold will flow in, prices will rise, exports will fall and imports increase.

If imports exceed exports gold will flow out, prices will fall, exports will increase and imports decline. The operation of this 'Specie flow-price change' mechanism will thus bring about an equality between exports and imports, taking of course, into account both the visible and invisible items.

Q 3 Explain with examples why certain countries export more than they import, while others import more than they export. (B A, 1940, 1928)

Q Account for the favourable balance of Indian foreign trade. How far does the excess of Indian exports over imports invalidate the theory that exports and imports must be equal? (B A, 1920)

The exports and imports of a country have a tendency to be equal, if there is any excess of one over the other, gold flow will be caused and this will bring about changes in prices and consequent adjustments in exports and imports. But when we speak of this balancing between exports and imports, we include both visible and invisible items; what we mean is that a country's credit balances with its debit.

If therefore, we find that certain countries are exporting more goods than they import we can be definite that these countries are importing some invisible services, which,

together with the visible imports make exports and imports equal. It may be that the country is paying in terms of the excess of goods exported for various services received from abroad, *e. g.* service of loans, of officers

Excess of exports who have to be paid pensions, of ships, represents pay- banks and insurance companies, of edu- ment for service cation of nationals in foreign universities received and of foreign travel. Payments have

to be made as much for these as for imports of commodities, and an excess of exports may represent payment for such invisible services imported from abroad. An excess of imports may similarly signify that the country is receiving interest on loans granted, repayment of loans, tributes, payments for services rendered in foreign countries, remittances from abroad, etc.

India's favourable balance of trade is a case in point. India has a permanent excess of exports over imports, and this excess represents payment by India for loans taken from England, for pensions and allowances of retired officers, for the

India's favour- services of British shipping, banking and insurance companies, for the education of Indian students in England and for the travelling expenses of Indian tourists. This excess of India's exports over her imports does not invalidate our theory

Home charge of the ultimate balance between exports and imports. India's exports of goods are in fact equal in value to the sum-total of her imports of visible and invisible items. What India has to receive on account of her exports is equal to what she has to pay for the visible and invisible services of foreign countries.

Q. 9. When we buy manufactured goods abroad, we get

the goods and the foreigner gets the money. When we buy the manufactured goods at home we get both the goods and the money. Examine this statement ( *B. Com., 1935* )

The above is a mistaken view that was first popularised by the Mercantilist writers but is even today held by those given to loose thinking. When we buy from abroad we pay in fact by our goods. We get the things that we want but cannot produce efficiently, and we pay for them by those things which we can produce best. We thus gain when receiving and gain when giving. Even if, for some time, gold flows out, this flow of gold automatically will increase our exports, and make our exports and imports equal. When, therefore, we buy from abroad, we get the foreigners' goods and the foreigners get our goods, there is a net consumer's surplus for either side.

Q 10 Examine the principal arguments for free trade and protection ( *B. A., 1937, 1926, 1922, 1920, 1917, (B. Com., 1932, 1930, 1928)* )

Q. Indicate the circumstances in which a country would gain more by protection than by free trade ( *B. A. 1942* )

If all countries had been on the same level of productive efficiency, free trade would have secured the most beneficial results for all. On the one side it would have meant that every country would be able to get at the cheapest possible rate things which it could not produce at all, or could produce inefficiently. On the other, it would have led to the fullest and most productive utilisation of the resources of every country.

In fact, however, all countries are not on an equal plane,

and it is, therefore, sometimes necessary to impose restrictions upon the freedom of international trade. Arguments for such restriction, or protection, have been many, and we can examine only the most important of them.

One argument for protection is that it would create a steady home market. When by means of protection new industries are developed, a home market would be created for the raw materials produced within the country. It is, however, often forgotten that the home market may be secured at the expense of a foreign market.

Another argument is that protection will encourage new industries and will, therefore, increase employment. We may, however, point out that protection will reduce imports, and will, therefore, reduce exports also. Employment may increase in the protected industries, but it will fall in the industries producing for export.

Another weak argument for protection is that restriction of imports from low-wage countries will tend to keep wages high in the protectionist country. It is pointed out that without protection a low-wage country will easily undersell a high-wage country and thus cause a collapse of the economic structure of the latter. The fallacy of this argument becomes apparent when we remember that trade depends on relative costs and not on relative wage-rates. The cost in a high-wage country may be low if labourers are efficient; and the cost in a low-wage country may be high if the labourers are inefficient. A high-wage country is not,

therefore necessarily in danger of being driven to the wall by a low wage country

The most important valid argument for protection is the famous *Infant Industry argument*. A country which has been late in starting her industries may face difficulties on account of the rivalry of stronger countries. If in such cases rapid development is desired temporary policy of protection would be justified. Protection will expedite the growth of infant industries into adulthood and will turn a temporary comparative disadvantage into a long period comparative advantage. It is, however difficult to choose the industries that really require and deserve protection and to withdraw protection after it has once been granted.

Another strong argument for protection is that it secures *diversification of industries*. It may be theoretically desirable for a country to develop only her most efficient industries and to depend on other countries for the supply of most of her needs. This interdependence works quite well in peace time. But when the situation becomes abnormal when a country finds its trade communications cut off by a war or anything of that nature, it realises that it would have been desirable to develop *diverse industries* even at a loss. The existence of a number of industries of different types gives employment to labourers of different sorts, always leaves a second string to the bow when one is broken and secures essential supplies even during abnormal circumstances. If such diversification

means a loss, the loss may be taken as an insurance premium paid to cover a risk.

In special cases, we may note in conclusion, production may be justified on social and political grounds. There is, for, example a strong case for protecting the shipping industry of a country, in the interests of both trade and defence. Social and Political Factors Protection may often be justifiably resorted to for saving a country from the disequilibrium resulting from the dumping of foreign goods.

Q. 11. What is meant by 'Mint Par of Exchange'? What are 'specie points'? Explain how they are arrived at. ( *B. A., 1938, 1929, 1923.* )

Q. What are the limits between which the rate of exchange normally fluctuates? Are there any such limits in the case of inconvertible paper? ( *B. A., 1934; B. Com., 1938* )

Q. "There are limits to the fluctuation in the value of bills of exchange." Explain this statement with reference to (a) Countries on the gold standard and (b) countries using inconvertible paper currency. ( *B. Com., 1945; B. A., 1944.* )

Q. Show how the balance of trade influences the foreign exchange rates. ( *B. A., 1945* )

When two countries carrying on trade with each other are both on the gold standard, the normal rate of exchange between their currencies can be easily calculated by comparing their gold contents. If the pound is equivalent to 155 grains of gold and if the mark is equivalent to, say, 5 grains, it easily



follows that 23 marks will have the same gold value as £1 and hence the normal rate of exchange will be £1=23 marks. This rate of exchange as determined by comparing the gold contents of the two currencies is called the *Mint Par of Exchange*.

If trade proceeds very smoothly as always to keep the balance of trade steady, the mint par of exchange will be the prevalent rate of exchange in the market. But the market conditions are rarely steady, in spite of the existence of a long-term tendency towards equilibrium, there will always be short period variations, causing exports to exceed imports to-day and imports to exceed exports to-morrow. These fluctuations will affect the demand for and the supply of bills of exchange and will cause the market rate of exchange to move away from the mint par.

If, for example, Germany has exported much to England and imported less, i.e. if Germany has a *favourable* balance of trade the German exporters will draw and offer for sale a large number of sterling bills of exchange. As the imports are small, the importers' demand for sterling bills will be restricted and hence the holders of sterling bills will find themselves unable to sell all of these. They, therefore, will be faced with the alternative of either selling the bills at a price lower than 23 marks for £1, or arranging for direct importation of gold.

But this importation of gold would involve expenses. If the expense for importing every £1 worth of gold is 1 mark, the German holder of sterling bills will find it profitable to

Constant fluctuations in trade

When Exports exceed Imports

Specie-import point

sell his bills at a price lower than 23 marks, so long as the loss is not greater than 1 mark ; it is, for example, more profitable for him to sell a £1-bill for 22·5 marks than to import gold directly ( in which case he will get a net sum of 22 marks only ). If, therefore, the supply of sterling bills is greater than the demand for them, the rate of exchange can go down to £1=22 marks, a point which we can call the *specie-import point*, because specie will come in, if the rate goes below this.

Similarly, if Germany's imports are greater than her exports in her trade with England i.e. if Germany has an *unfavourable* balance of trade, the demand for sterling

When Imports exceed Exports bills will be greater than supply, and sterling will no longer be available at 23 marks. The importers will either have

to pay more than 23 marks for every £1-bill bought or to export gold. Here, again, the expenses of exporting have to be considered, and in view of these it will be worth while

Specie-export point for the importers to buy sterling at a rate not higher than 24 marks. If the rate goes above 24 marks, it will be cheaper to export

gold at the cost of 1 mark for every £1. The rate of £1=24 marks can be called the *specie-export point*.

These two points lie on either side of the mint par of exchange, separated from it by the expenses required for exporting or importing gold.

Normal Limits of fluctuation These expenses normally include cost of transportation, interest on the amount of gold in transit and the insurance charges. The two points mentioned above provide the limits between which the rate of exchange can normally fluctuate.

When gold standard is suspended and there is a régime of inconvertible paper, there can be no mint par of exchange

The equilibrium rate of exchange will be any rate that brings into equilibrium the supply of bills and the demand for them

There can apparently be no limit to the fluctuation of exchange. But, even in such cases the fluctuations cannot go too far. If the exchange depreciates, exports will increase and this may cause the exchange to rise again, similarly if there is an appreciation of the exchange, imports will be stimulated and this in itself may cause a tendency towards a fall of the exchange rate

**Q 10** Examine the causes of fluctuations of the foreign exchange ( *B Com., 1937, B A, 1936* )

The normal rate of exchange between any two currencies would be the mint par of exchange as determined by the gold contents of the two currency standards. This rate can vary upwards and downwards so long as it does not go beyond the limits set by the specie points

There are mainly three factors causing fluctuations in the rate of exchange. The most fundamental is, of course, the condition of trade or the relation between exports and imports. If exports exceed imports supply of foreign bills will expand, and consequently, the foreign currency will fall and the home currency will appreciate. If on the other hand, imports exceed exports, the exchange will depreciate

Banking factors may also cause fluctuation in foreign exchange. If the rate of interest rises funds will be attracted

from abroad and if the rate falls, funds will flow out.

Banking factors — capital movements These movements of capital will necessarily produce effects on the exchange rate, an inflow of capital producing the same effect as an export of commodities and an outflow the same as an import of commodities.

Currency changes Changes in the *Currency Conditions* may also affect the rate of exchange—an inflation will necessarily cause a depreciation, and a deflation will lead to an appreciation.

Speculation and State action The rate of exchange may also be affected by speculative transactions in foreign exchange and by deliberate attempt to influence it by the Government or the Central Bank.

Q. 11. Discuss the effect on foreign trade of an alteration in the rate of exchange. Distinguish between the immediate and the long period effect. (*B. Com.*, 1940.)

Q. Show how a depreciating currency stimulates exports. (*B. Com.*, 1937.)

Q. Examine the effects of a depreciating currency on foreign trade. (*B. Com.*, 1948.)

When currency is depreciating, a unit of home currency becomes equivalent to a smaller amount of foreign currency, and this enables the home producers to sell their goods abroad at a price cheaper in terms of foreign currency. If the rupee, for example, would suddenly drop from 18d. to 16d. every one-rupee commodity would be cheaper in England and hence the demand for these in England will rise. A depreciating currency, by making our goods cheaper abroad, can act as a bounty on exports.

Depreciation stimulates exports

The beneficial effect of this depreciation will, however, be experienced only for a short period. In the long period, difficulties are likely to ensue. *First*, the depreciation of the currency will raise the internal cost of production making it impossible for the producers to produce for one rupee the articles which could formerly be produced at that cost. *Secondly*, this depreciation of currency, by raising prices at home, is likely to create labour troubles for the producer and budgetary troubles for the Government. *Thirdly*, foreign countries may refuse to admit these additional exports of ours, they may impose respective duties on goods that seek to enter their country through 'exchange-dumping'. And *lastly*, other countries may launch a policy of competitive depreciation, and, as a result, no one will gain in the end.

Similarly, it can be shown that the short-period effect of an appreciation of currency is to stimulate imports and to discourage export. But the long period effect will be different on account of decline in costs protective tariff on foreign goods, etc.

It is noteworthy that an appreciated exchange (brought about by an excess of exports) is sometimes called a 'favourable exchange', this is a relic of the idea that an export-surplus means a 'favourable' balance of trade. As a matter of fact, no exchange is *favourable* in the long run, and in the short period, it is a depreciating exchange that is likely to produce a favourable effect.

Long period  
effects

Appreciation  
stimulates  
imports

Favourable  
exchange,  
(B. Com., 1937)

## CHAPTER X

### Public Finance

Q. 1. What is public finance ? Is there any essential difference between public and private finance ? (B.A., 1943.)

Public Finance is the name given to the scientific study of the revenues and expenditure of the state. Just as an individual has to earn an income and to spend it for attaining the maximum possible amount of satisfaction, the government of a country has also to earn an income and spend it for securing the largest possible degree of social welfare. In the earning of an income a choice has to be made among alternative lines available. The state has to decide not only how much it will have to raise but also the manner in which the revenue will be gathered in Taxes, loans, government business, currency inflation, all are available with their various effects on revenues, incomes and social welfare, and the government has to choose with care the methods it will apply. Similarly, in the choice of the different channels of public expenditure a careful regard has to be paid to the various effects that are likely to be produced on production and distribution. Public finance is a study of all the problems that arise as the result of government's attempts to raise its revenue and to spend it and the science is generally divided into three parts, namely, the study of the government revenues, the study of public expenditure and the study of government debts.

Broadly and fundamentally, public finance and private

finance are similar. By private finance we mean the income-expenditure problems of a private individual. A private individual has to choose his method of earning his income and the ways in which he will spend it. his aim is to get a maximum of satisfaction. The government also has to make a choice between alternatives and its aim is to secure a maximum of social advantage. The government however is more free than the individual in making the choices. An individual's method of earning income and the amount of his income is very often conditioned by his environments. The government can control environments and can, therefore, decide not only the methods of earning its revenues, but also the amount of revenue it seeks to earn. Within limits a government can first decide how much it will spend and then proceed to raise a revenue adequate for its purpose. All this the government can do because of the sovereign power it enjoys. It is in exercise of this power that the government can force people to pay taxes, secure command over goods by currency inflation and compel people to lend to it. Ultimately both a private individual and a government have to balance their respective budget, but the government has surely more facilities and opportunities than a private individual has in this respect.

Q 2 Define a tax. Explain and illustrate Adam Smith's canons of taxation. (B A 1931 1928 1925 1919)

Q Discuss the main considerations which usually underlie the system of taxation in a country. (B A 1941)

Q State and discuss Adam Smith's canons of taxation. (B A 1945)

A tax is a compulsory contribution made by the citizens

for the general purposes of the State. The characteristic feature of a tax is the absence of a *quid pro quo*, i. e. a direct return for the payment made, and it is this characteristic that distinguishes a tax from a fee taken by the Government for specific services.

The main considerations which usually underlie the system of taxation in a country are even today based to a large extent on the canons of taxation outlined by Adam Smith in 1776. His first canon is that of *equality*. He holds that citizens should "contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, that is in proportion to the revenues which they respectively enjoy under the protection of the State". This canon of equality has been interpreted by some to mean proportional taxation and by others to mean progressive taxation. A little reflection shows that real equality can be secured only by progressive taxation, i. e. by taxing higher incomes at a higher rate than the lower incomes; and this principle of equality through progression has been accepted today by every country.

The second canon of Adam Smith is that of *certainty* which emphasizes the need of specifying accurately and definitely the amount of tax to be paid by a citizen and the time and place for payment.

The third, the canon of *convenience* states that "every tax ought to be levied at the time or in the manner in which it is likely to be convenient for the contributor to pay it". The cultivators, for



example, should be asked to pay their land tax when they get cash by selling their crops, salary earners at the beginning of every month, and businessmen at the end of the year

The last canon is that of *Economy* 'Every tax', says Adam Smith, 'should be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the Public Treasury', or, in other words, the cost of collection should be low. An income tax on low incomes involves a very heavy cost of collection and this is one of the reasons why an exemption limit is usually prescribed

|   |   |
|---|---|
| Other considerations                      | Adam Smith's canons, however, do not provide a complete basis for judging the adequacy of a modern tax system. A sound and scientific system of taxation should also have the following considerations in view. First the taxes must be |
| Adequacy                                  | <i>fiscally adequate</i> , i.e. they must raise a total revenue sufficient for meeting the recurrent expenses of the State. Secondly, they must be <i>elastic</i> , in  |
| Elasticity                                | order to enable the State to increase its income when necessary without resorting to new legislation. And, thirdly, there must be a proper  |
| Balance between Direct and Indirect taxes | <i>balance between direct and indirect taxes</i> the direct taxes being used to tax the rich progressively and the indirect ones for making the poor pay at least something   |

Q 3 Examine the arguments on which progression in taxation is justified. Distinguish between proportional and progressive taxation. (B.A., 1937-1930, B.Com., 1941, 1939, 1937, 1930)

Q. Examine the merits of the different interpretations placed upon the principle of justice in taxation. (*B. Com., 1934, 1929.*)

|                           |   |
|---------------------------|---|
| Justice in taxation       | in which he emphasized the canon of equality in taxation, it has been recognised that the whole tax system, or at least, the major part of it, should be so devised as to secure the utmost justice between one tax-payer and another. Some have, |
| Different interpretations | however, interpreted this justice principle as leading to proportional tax and some to a system that will "leave them as you find them", i.e. will not try to affect the existent inequalities.   |
| Progressive taxation      | The soundest interpretation of the justice principle is that taxes should be so levied as to impose on the tax-payers the <i>least aggregate sacrifice</i> , and this naturally leads to <i>progressive taxation</i> .                            |

The justification of progressive taxation is found mainly in the diminution in the marginal utility of money with an increase in income. A man with a larger income can easily spare much more than a man with a smaller income, because the former's expenditure consists largely in buying comforts and luxuries. As a man's income increases, he tries to purchase things that satisfy less and still less urgent wants, and hence if a man with Rs. 50 can spare Re. 1, a man with Rs. 500 can spare much more than Rs. 10.

Progressive taxation thus not only secures an equitable

distribution of the sacrifice that tax payment entails it definitely improves the distribution of wealth. If the rich are taxed at a higher rate than the poor, and if at the same time, the Government spends more for the benefit of the poor than for the rich, the inequalities of wealth in the community will be considerably modified.

Modern economists justify the principle of progression by holding the doctrine of *Least Aggregate Sacrifice*. The sacrifice of society as a whole will be less if ten rupees are taken from a man with Rs 200 than if one rupee is taken from a man with Rs 20 only. This doctrine of least aggregate sacrifice implies first, exemption from taxation of all incomes below a certain level; secondly, moderate taxation of moderate incomes; and thirdly, very steeply graduated taxation of very high incomes.

Q 4 How far is equity in taxation attained by an income tax and a tax on expenditure? (B Com. 1935)

Q The rich should pay more in taxes than the poor. Why? Illustrate how in practice certain taxes follow this principle and others violate it. (B A 1930)

We have already explained why the rich should pay more in taxes than the poor. All taxes however do not follow this principle mainly because of the practical difficulty of applying progression. The best taxes in which progression can be applied are the income tax and the inheritance tax. The rate of income tax may be graduated making it higher with every rise in income and a further

element of progression and justice can be introduced by *taxing unearned incomes* at a higher rate than earned incomes. Most countries add a super-tax to the income tax and thus increase the steepness of the graduation.

An inheritance tax can also be graduated—both with reference to the value of the inheritance and with regard to the distance of relationship between the deceased and the successor. Every inheritance is in a sense a windfall, and it is more so when succession goes to a distant relation. It is, therefore, proper that an inheritance tax should be graduated according to the distance of relationship.

An expenditure tax and a sales tax may also secure some amount of progression, because these are likely to fall more upon the rich who spend more and buy more than upon the poor.

There are, on the other hand, taxes which violate the principle of equity and do not admit of progression. Some taxes are definitely regressive. Such are, for example, poll taxes, the burden of which will fall more heavily on the poor than upon the rich. Such are also all indirect taxes or taxes on commodities. These raise prices to the same extent for the poor as for the rich, and hence make the burden greater for the poor than for the rich. Some indirect taxes are necessary for every State, but the tax system should be so devised that, *as a whole*, it may be progressive.

Q. 5. A tax system should be so devised as not to reduce the national income or check its growth. Take the tax

system of any country with which you are familiar and consider how far that system conforms to this standard (*B Com, 1943*)

Every tax produces three different kinds of effects (a) effects on the power to work and to save, (b) effects on the desire to work and to save and (c) effects on the allocation of resources between different lines of work or branches of production. A tax which raises the *power to work* increases present production, a tax which increases the *power to save*, enables one to provide capital for further production. If a tax increases the *desire to work*, it is beneficial from the stand point of current production, if it increases the *desire to save* it stimulates future production. Lastly, if any tax diverts resources from more productive lines to less productive lines, it will reduce the natural dividend and in the reverse case the national dividend increases.

These are the general principles. Varieties of taxes exist and every tax has a multitude of effects. A few general instances can however be selected. A tax which falls more heavily upon saving than upon income, e.g. a death duty will injure the growth of capital. A tax which falls heavily upon current expenditure, e.g. a sales tax will affect present production. An unwisely chosen protective duty may cause an undesirable division of resources. A tax which reduces incomes so much as to stimulate the taxpayer to exert himself more for earning a higher income may be beneficial from the point of view of current production.

In India, it has often been argued by industrialists that the super taxes and high corporation taxes have discouraged the growth of capital. A similar complaint has been made

against the Excess Profits tax. Many economists have held that the Indian protective duties have encouraged inefficiency and have thus caused at least a check on the growth of wealth.

It is, however, to be remembered that while taxes as a whole have the net effect of reducing the national dividend to some extent, expenditure by the government of the amount collected through taxation may help its growth. It is, of course, desirable to choose those taxes which cause a minimum of injury to the national dividend.

Q. 6. Discuss the merits and demerits of direct and indirect taxes. (*B. A.*, 1938, 1924; *B. Com.*, 1940, 1928.)

Q. Examine the advantages and limitations of raising revenue by indirect taxes. (*B. A.*, 1944)

A direct tax is a tax which is paid wholly by the person on whom it is imposed by the Government, and an indirect

|                              |  |
|------------------------------|--|
| Direct and<br>Indirect taxes | tax is one which is imposed on one person, but is shifted off to others by the former. |
|------------------------------|--|

In the case of a direct tax, he who pays the tax bears the burden or incidence; in the case of an indirect tax, he who pays the tax in the first instance is able to recover the amount, wholly or partly, from other persons. The best example of a direct tax is income tax; the best example of an indirect tax is a commodity tax the burden of which is capable of being shifted by the seller on to the buyer.

A direct tax has the advantage of being equitable because it can easily be graduated. It is able to secure for the State

|                               |  |
|-------------------------------|--|
| Advantages of<br>direct taxes | a large revenue and, in most cases, the revenue can be made elastic. The Government of Great Britain has used the income |
|-------------------------------|--|

tax during the present war for increasing its income. A direct tax has the further advantage of being direct. It follows Smith's canon of certainty, because every citizen knows and feels what he has to pay. The State also can make a correct anticipation of what a direct tax will bring to the public exchequer. It is economical and is less liable than other taxes to evasion as it is collected at the source.

On the other side it may be argued that a direct tax is directly felt by the people and therefore people resent it. Administrative difficulties are also great because in every case an assessment is necessary and this may lead to hardships in some cases and corruption in others. Besides, if the poor have to be made to pay something indirect taxes have to be imposed because direct taxes on small incomes would make the revenue small but the cost of collection great. It is also argued sometimes with some truth that a direct tax discourages saving and production.

Indirect taxes on the other hand are not felt much by the people. They pay it almost unconsciously and hence, there is little resentment except when a high tax is put on a necessary article. An indirect tax secures a large revenue in poor countries. In India customs duties alone raise half the total revenues of Central Government. In most countries it is necessary to make the poor pay something and this can be done only through indirect taxes.

The disadvantages of indirect taxes are patent. The greatest objection against them is that they are regressive in character and fall more heavily on the poor than on the rich. Most indirect taxes

are imposed on necessities because, otherwise, consumption will fall off and revenues decline. This taxation of necessities may reduce essential consumption and thus affect the well-being of the people.

It is, however, necessary for every State to impose both direct and indirect taxes. The tax system as a whole should be progressive and with a view to securing this, the direct taxes should be so steeply graduated as to neutralise the regressive effects of the indirect taxes.

Combination of  
Direct and  
Indirect taxes

Q. 7. Write a note on the incidence of tax. (B.A., 1930.)

The incidence of a tax is upon those who ultimately pay it. In the case of indirect taxes the seller will try to shift the whole, or as much as possible, of the tax on to the buyer. The incidence is wholly on the buyer if the seller can raise the price by the full amount of the tax; partly on the buyer and partly on the seller if the price does not rise by the full amount of the tax; and wholly on the seller if he cannot raise the price at all.

Distribution of  
the incidence

The seller's ability to raise the price by the full amount of the tax will depend on the elasticity of his supply. If he cannot withdraw his supply, or any part of it, he cannot raise the price. Hence, the more inelastic the supply the more likely it is that the burden will be upon the seller; and the more elastic the supply, the more likely it is that the burden will be upon the buyer.

Elasticity  
of supply

The buyer's ability to resist the seller's attempt to shift the tax will depend on the elasticity of his demand. If his



demand is inelastic he will have to purchase even at a high price, and, therefore, the seller will find it easy to shift the tax. If his demand is elastic the seller will fail, because the buyer will reduce consumption and thus compel the seller to accept low prices that may not cover both the cost and the tax

The principle that emerges is thus as follows The burden of taxation will be divided between the buyer and the seller in proportion to the ratio between the degree of inelasticity of demand and the degree of inelasticity of supply The more inelastic the demand, the greater will be the burden on the buyer, the more inelastic the supply the greater will be the burden on the seller This principle applies not only in the case of taxes imposed on goods entering domestic trade but also in the case of customs duties imposed on goods entering trade between natives

Q 8 When is a government justified in raising large funds by loans ? ( *B Com. , 1938* )

Q Discuss the main purposes for which loans and taxes should be used by the State ( *B A , 1940* )

Q Discuss the legitimate purposes for which public debt may be incurred ( *B A , 1943* )

Taxes are recurrent sources of revenue and it is, therefore, proper that they should be used for meeting the recurring expenses of the State Every State has to incur regular expenses for carrying on its normal functions and taxes undoubtedly are appropriate sources of revenue for meeting these charges.

But every State has to incur at times some extraordinary capital expenditure. A war, for example, may necessitate a huge expenditure that cannot be adequately met by increased taxation. Constructive programmes like railway construction, construction of irrigation canals, or the launching of a development plan, may also require capital expenditure that cannot be met from the annual revenues. It is in these cases that the State has to raise loans, either internally or abroad.

It would certainly have been better if all expenses could be met by taxation. A loan also will necessitate taxation in future for paying interest and repaying the principal, and it is certainly desirable to avoid these heavy future burdens. But loans are inevitable when huge lump-sum expenses are necessary, for no amount of taxation can provide funds adequate for war or even for a railway construction.

A loan taken for a war is a deadweight burden. The world would be a better place to live in when war would disappear, and with it the war debts. But in the present-day conditions we have to take wars and war loans as an evil necessity.

When a loan is taken by the State for a productive purpose, no objection can be taken against it. If, for example, the State borrows for constructing a railway, the income from the railway will in most cases be adequate for meeting the interest and sinking fund charges. The railway, therefore, feeds itself and the loan taken for constructing it is certainly justifiable.

Q 9 What are the different forms of public debt ?  
Suggest measures by which the burden of public debt may  
be diminished ( B A 1939 )

The loans taken by a Government can be classified in a number of different ways. They may first be divided into *internal debts* and *external debts* according as the creditors of the State are its own nationals or foreigners. They can also be classified according to the length of time for which they run. Some of these are *funded* debts or debts repayable after long periods and some are *unfunded* or *floating* i.e. repayable after a short period. We get in India different types of Government debts, ranging from 3½ per cent Government paper for which no specific time limit exists to the treasury bills which are repayable two or three months after issue. Another method of classification is that between *productive* debts or those which are applied in such a manner as to yield an income sufficient to meet the debt charges, and *unproductive* or *deadweight* debts like war loans.

The burden of these public debts can be reduced in a number of different ways. It is possible, for example, to establish a *sinking fund* for the purpose of debt-redemption. Every year a definite sum may be set aside and utilised for redeeming old debts. It is also possible to impose a *special debt redemption levy* or *capital levy* upon people with large capital sums and the receipts of this levy imposed once for all may be utilised for paying off the creditors.

The *budget-surplus* may also be utilised but it is not possible to expect much from this method, because Budget surplus surpluses are generally small and often non-existent.

The burden can be reduced also by a scheme of conversion, i.e. by forcing the holders of bonds to convert these into new bonds bearing lower rates of interest. The debt will not disappear but the annual burden of it will be smaller on account of the conversion of a high interest rate into a low one. In some cases, the Government may float a new loan at a low interest and pay off the holders of the old bonds. This also secures a conversion in effect.

It is also possible, though undesirable, for a Government to repudiate its debts. The debts of the Czarist Government were repudiated by the Bolsheviks when they came into power and there have been other examples of such repudiation. A Government repudiating a debt may, however, often injure itself, for it may be difficult for it to raise a loan in future.

Q. 10. "When a government pays its way by means of currency inflation, the people of the country avoid taxation." Examine this statement. (*B. Com., 1944.*)

It is generally said that there are three ways in which a government can meet its financial needs : taxation, borrowing and inflation. Of these, taxation is the normal method of meeting the normal demands upon the government. But whenever there is any exceptional demand for government expenditure, taxation proves inadequate. A government following the principles of sound finance would in that case

try to secure funds through borrowing. But when the needs are exceptionally large as in a war, taxation and borrowing taken together prove insufficient. Very few governments can in such circumstances resist the temptation of adopting a simple alternative that presents itself, namely, creation of new money specifically for war expenditure or for similar other purposes.

Superficially inflation secures to the government additional purchasing power without recourse to the unpopular course of very stiff taxation. The ordinary citizen also does not mind so long as the inflation is not a galloping one, but he would generally protest against every increase in taxation.

It is however, not often realised that inflation involves taxation and that also in a very inequitable manner. The main problem of governmental finance is to transfer 'resources from the hands of the citizens to the hands of the Exchequer. If this transference is brought about by inflation, apparently the government only appears as a new buyer with a large amount of money to spend. But, in fact, the expenditure of newly created money raises prices and the ordinary citizens, whose incomes do not rise as fast as prices, have to curtail consumption. They are thus forced to buy and use less commodities, that is they have to desist from buying what the government is buying with the newly created money. If taxation means that people surrender a part of their command over goods for use by the state, inflation means forced reduction of private consumption and undeclared taxation.

Inflation is really worse than taxation. The burden of taxation can be distributed equitably through progressive rates and exemption of low incomes. The burden of inflation

generally falls more heavily upon the labourers and the lower middle class whose incomes do not rise at the same rate as prices, and less heavily upon the richer classes. Businessmen and producers are able to make large profits in a period of rising prices. The burden of inflationary taxation is therefore very inequitably distributed. Besides, an inflationary process, once started, cannot be easily controlled. The ultimate result is galloping inflation and flight from the currency which make the whole monetary financial and industrial structure chaotic.

---

## CHAPTER XI

### State Control and Socialism

Q. 1. In what circumstances, if any, would you advocate state interference with production and distribution? (*B. Com., 1944.*)

The classical economists and their followers were generally against any sort of state interference. They based their philosophy on the comfortable assumption of smooth and perfect competition, and in their opinion, the volume of output would automatically be the largest possible under a *laissez faire* policy. The actual distribution of the nation's income also appeared to them a fairly correct representation of the social worth of the services performed by different groups of persons.

This complacent belief no longer exists. It is by no means admitted now that all is well in a competitive system,

and besides, competition has given place to monopolies and semi monopolies in most cases. The distribution of the social income in unequal proportions is no longer accepted as ethically and logically right. The end of laissez faire has been marked by a realism in the opposite direction. State interference has come to be considered as normal as laissez faire in the nineteenth century.

There are particularly some circumstances in which state interference is regarded as indispensable in every country.

There is a *prima facie* case for state control where private enterprise is leading to a wasteful use of resources or to the production of commodities the use of which is injurious from the standpoint of social welfare. The government find it necessary to interfere when private entrepreneurs carry on cut throat competition and through reckless devices waste labour and capital that could be used profitably in other directions.

The most important case of state control over production comes when a monopoly is formed. A monopoly seeks high profits; it restricts output and employment. There have been cases of deliberate destruction of finished goods for the purpose of keeping up monopoly prices. Government may control prices or profits and in some cases it may be possible to prevent monopolies from coming into being through anti combination laws.

State interference in distribution is justified in every case of gross inequality of incomes. It is possible for the state to reduce inequalities by progressive taxation on the one hand and beneficial public expenditure on the other. More direct methods may sometimes be necessary *e.g.* minimum wages legislation, social insurance, putting a ceiling on pro-

fits etc. We may note in conclusion that state-interference is necessary in the interests of the workers in order to secure not only good wages, but also good working conditions and shorter hours of work.

Q. 2. State the arguments against state-interference with production and distribution. (*B. Com., 1943.*)

The supporters of the capitalistic system of production are against all forms of state control. They argue that free competition secures a fair deal for every one and gives each man what he deserves. Competition in economic life is according to them akin to the struggle for existence in the animal and vegetable kingdom and the result in each case is the survival of the fittest. Competition develops keenness, intelligence and skill and is therefore the greatest stimulus to progress. Even if competition sometimes leads to monopoly, the benefits of monopoly are to be put against its evils, and in the opinion of the *laissez faire* economists no evil is greater than the evil of state-interference. They point out the economic progress achieved under *laissez faire*, and hold that stagnation of economic life will be the only result of a large measure of state control.

These arguments are, of course, largely fallacious. There can be no analogy between the biological evolution and the economic evolution, and we do not certainly want that sort of survival of the fittest which is experienced in the animal or vegetable kingdom. Besides, 'free' competition is a hypothesis very far away from facts. Competition is often absent and even when it is present, it is very much imperfect. The result is that the benefits of the so-called economic progress are unevenly distributed. Large numbers suffer



either because of the scarcity of consumable goods or because of the lack of the means to purchase them, while a small number of persons can derive large monopoly profits, by curtailing output by putting resources to wasteful use, or by deliberately suppressing new productive capacity. State control will certainly reduce the *desire* of some to apply their efforts for increasing the social output, but it will on the other side increase the *power* of most of the people to undertake efforts.

Q 3 How far, in your opinion, is state control of prices and production justified in times of war? (*B Com*, 1943)

The evils of a *laissez faire* economy become markedly patent in a period of special stress like war. A war means a large scale use of resources for purposes other than civilian consumption and this, combined with cessation of imports and scarcity of labour, causes a considerable reduction of supplies for the ordinary consumer. On the other side, large amounts of public expenditure bring additional incomes in the hands of the people. These two causes combine to raise up prices. Speculative transactions, hoarding of goods, panic purchases—these are all common features of a war economy, offering large opportunities for profit to the unscrupulous traders and merchants and bringing sufferings to the ordinary consumer.

Control of prices is therefore indispensable in war time. In the absence of such control, the inflationary spiral would move sharply upwards and if the brakes are not applied in time, it may be difficult to prevent a complete monetary chase in the end.

But no control of prices can be made effective without

control over production and supplies. The inefficacy of price control without control over supply has been amply demonstrated in India during the present war. In the interests of a smooth war economy, it is therefore essential that the government should exercise control not only over prices, but also over production and supplies.

Control of production is necessary in a war period because of another reason. We have seen that a war means diversion of a large part of the resources of the country from civilian consumption to military consumption. The resources available being limited in quantity, it is necessary that every unit of these should be used in the most *beneficial* manner. In an uncontrolled economy, resources are used in the most *profitable* manner and supplies are fairly large, there is some justification for the assumption that what is profitable is also beneficial. But when in a war economy, a small proportion of the total resources of a country are left for civilian use, it is necessary to be careful at every step and see that every material is put to its most beneficial use.

Q. 4. What is socialism? Briefly discuss its aims and purposes. (B. A., 1943.)

The evils of the capitalistic system of production have led many to look for alternatives, and socialism is the most important among them. A socialistic trend has been visible in practically every country, and in the U. S. S. R. a definitely socialistic economic programme has been put into operation.

*Socialism is the name given to an economic system which* (a) transfers the command over the material equipments of production from the hands of private capitalists to those of

the state (b) puts collective action as the prime mover in the place of private enterprise, and (c) seeks to remove or at least to reduce the inequalities in the distribution of wealth. In each of these aims and purposes, the contrast between capitalism and socialism will be patent.

A socialistic economic policy will therefore have the aim of eliminating capitalism and this aim can be realised by transferring the ownership of land and other material means of production in the hands of a public body. This body will run the important industries as public utility services. Ordinary citizens will on the one hand derive their incomes from working in the state owned industries and their consumption goods from the outputs of these industries. Conditions of work and hours of work will naturally be more satisfactory than are experienced in the capitalist system.

The second aim necessarily follows from the first. The capitalist economy is linked up with the profit motive and a new attitude to life cannot be created unless this profit-motive is substituted by a motive of a higher order. There may be difficulties due to the sudden disappearance of an incentive to which people are habituated but the socialist hopes that new incentives can be created.

The third aim ought really to come first for it is out of the realisation of the injustice and evil effects of the inequalities of distribution that socialist ideas grew. Socialism, therefore, must aim at correcting these inequalities. The task is difficult because no workable and logical formula for the distribution of wealth can be discovered in the absence of a market for the valuation of labour and services, and of course, it is this market that socialism seeks to abolish.

The socialist however argues that every reduction of inequality is a step towards better things, and even if perfect equality in distribution is unattainable, a large measure of reduction of inequalities is possible.

In conclusion, we should note that there are degrees of socialism. *Some would consider a private-enterprise economy with some measure of central planning as sufficient.* At the other extreme there are socialists who would hold that socialism means an entirely new way of life and if we are unable to scrap the old system altogether, we shall not be able to build up the new one.

There are also differences in methods. The fabian socialists expect to secure a socialist economy through gradual changes in legislation. The syndicalists want to secure control of industries by labourers' syndicates through a general strike. The Marxian socialists or communists believe that the end of capitalism is historically determined and that this end should be expedited by a revolution that would establish proletarian rule at first and a socialist state later.

Q. 5. How far in your opinion, is socialisation of the instruments of production likely to promote the happiness and prosperity of mankind ? ( *B A., 1945.* )

Socialisation of the instruments of production will mean fundamentally the abolition of the economic system in which the profit-motive is the primary incentive to action. If this socialistic programme operates according to expectations, a number of benefits can be expected.

First, socialisation of the instruments of production will mean the elimination of the capitalist class. Wealth will cease to accumulate in the hands of the few and a

better distribution of wealth can be expected. This in itself will raise up the standard of life of large sections of the population, increasing in this way the welfare of the whole society

Secondly, socialism will secure the end of privately-owned monopolies. Thus, deliberate reduction of output, high prices, discriminating prices, suppression of innovations and a host of other evils of monopoly-capitalism will disappear. The state can be expected to produce the essential requirements of the people in large quantities.

Thirdly in a socialistic economy, the people can expect to get the goods that are necessary for their life and efficiency. In a capitalistic economy goods are produced in accordance with 'effective demand', i.e. demand backed by purchasing power. Luxury goods are therefore produced by using resources which could be used for producing necessities for those whose demand is strong but 'ineffective'. In a socialistic economy, the sovereignty of money and demand will certainly disappear.

Lastly, a socialistic economy can be expected to remove or reduce the severity of a great evil of the present system, namely, the trade cycle. One of the worst features of the present-day economic life is that progress is never steady. There are ups and downs, one following the other, in the production of output, volume of employment and incomes. Economists agree that the evil of the trade cycle is mainly due to the fact that private entrepreneurs decide for themselves when to advance and when to retreat. In a socialist state, where every investment will be under the control of the state, it will be easier to keep the volume of employment steady at a high level.

It is of course necessary to note that socialisation is not free from difficulties. A complete or nearly complete socialisation may mean loss of the individual liberty to choose between one employment and another or between one consumption and another. Secondly, the problem of deciding what to produce and how much to produce will be a difficult one in the absence of a freely operating price mechanism. The successful operation of a socialist system must be largely dependent on the existence of a body of good administrators and even the best of such administration is bound to be bureaucratic. It is also pointed out by many that the incentive to produce more, that is stimulated in a capitalist society by the possibility of earning more, will not be operative in a socialist system and consequently, the socialist experience may become an experience of stagnation.

The socialist will point out that new types of institutions will develop new types of incentives. He would emphasize the success of Soviet Russia in achieving a tremendous economic progress, particularly in the years following 1928, through the five-year plans. The rest of the world has also seen the end of *laissez faire* and an increasing degree of socialisation is coming in every country.

Q. 6. "Anything that tends to equalise the distribution of wealth secures a more economical application of productive power." Explain this statement.

What in your opinion are the measures necessary for bringing about a more equalitarian distribution of wealth? (*B. Com., 1945.*)

The present inequality of distribution is uneconomical from more standpoints than one. First, it has meant poverty for a large number of persons, particularly the manual workers. Their power to work has been seriously affected by their lack of means. The system of distribution we have means that workers as a class are ill-nourished, uneducated and untrained. A large amount of potential productive power is lost on account of the inadequacy of the means available to the labourers.

Secondly, the unequal distribution of wealth means a

loss of social satisfaction. If we accept the position that a unit of money means a smaller satisfaction to the rich and a larger satisfaction to the poor we have to admit that every increase in inequality reduces the sum total of social welfare and every step towards equality increases the social well being.

Thirdly a serious result of the unequal distribution of wealth is that much of the purchasing power available goes to persons who do not spend it. Saving of course is essential for the growth of capital but there are two factors which are more important. (a) Saving must not be so large as to

following from the capitalistic system of production.

A more equalitarian distribution of wealth can be attempted in many ways. Creation of avenues for employment through public investment and other measures will itself go far. In a community in which full employment or at least a high level of employment is maintained a large part of society's total wealth will necessarily come to labourers and primary producers. Secondly it is possible to reduce inequalities through progressive taxation exempting the poor from payment of taxes and imposing steeply graduated taxes on the richer classes. This may be combined with a system of death duties which will bring to the state the accumulated wealth of one generation before it passes as unearned income, to the next. Thirdly the government may provide free or subsidised services for the

\*

income will be guaranteed to all and unemployment sickness, old age and other benefits will be given in deserving cases.

Q 7 Point out the main features of the communist experiment in Soviet Russia. In what important respects does it deviate from Marxian socialism? (B A 1942)

It is yet too early to judge whether the communist

experiment in Soviet Russia has been successful and to what extent the communist ideals have been achieved. The first few years after the Revolution were years of disorder and trial and steady progress could be possible only after 1927 when the first five year plan was launched. The success of the first plan led to the adoption of a second in 1933 and a third in 1937. War broke out in 1919 and what Russia achieved was secured during the twelve years from 1927 to 1939.

The economic policy adopted in Russia may be taken as representing the initial stages of a communist experiment. The first and foremost feature of Russian communism has been a wide extension of state-socialism. The government is the owner of all public utilities, armament factories, heavy industries, banking and credit institutions and all trade is carried either by the government or under its control.

In agriculture, the main principle is that of collective farms, a system of productive co-operation among the members of the same village. The land legally belongs to the state and individual holdings are merged into the village collective farm on which every one works, and the output of which every one shares. The large-scale farmers or 'kulaks' are being eliminated.

There is no wage-earning labour except in the state-owned industries. Workers in collective farms work as co-operative producers, and if money wages have to be earned, employment has to be sought in the public services or in socialised industries.

Small industries are allowed to remain in private hands, provided the laws regarding hours of work, methods of trading, wages and prices are obeyed.

The central planning board has to decide a number of important questions—the amounts of various types of goods and services to be produced, the rate at which capital for the future is to be provided out of the income of the present, the rate at which advance planning is to be effective, the changes in technique that are to be introduced and so on.



The board possesses absolute power over the economic resources of the country

Labour as a social class is given all possible consideration —through security against unemployment, provision for medical and other needs, including educational and cultural development, allowances for vacation, free trips to holiday resorts, production bonuses etc

There are however important deviations from the Marxian theory. The Russian revolution itself cannot be fitted into the Marxian doctrine that a proletarian rising and a socialist state are the inevitable outcome of a capitalist system where capital concentration was carried far. Russia was not a highly industrialised country in 1917 and the revolution there was more political than economic. The Russians have not yet been able to put into practice a socialist scheme of distribution. Inequalities exist, though they are not so glaring as in other countries, the highest paid classes are those of technical and administrative experts. A technical bureaucracy has come into existence and its power in the state is almost supreme. Money has not been eliminated and the rouble is supposed to rest on a firm gold basis. Money, however, is not automatic in its influence because of the strict control maintained over prices and the foreign exchanges. Individual savings out of earned incomes are allowed, but these savings cannot ordinarily be lent to any one other than the government.

The Russians, of course, claim that the true contents of Marxism are there which have come through the interpretations given by Lenin and Stalin. They also point out that communism in their country is in an infant stage and therefore it should not be judged by the transitional measures that have been adopted

---

## APPENDIX

### 1. Saving and Spending. (*B. Com., 1940.*)

Saving and spending are two ways of utilising one's income and both of these have importance in economic life. The real difference between saving and spending is that the former represents a decision to use money for future consumption, while the latter stands for a decision to use money for current consumption. A large saving will, therefore, reduce the current demand for consumption of goods; a large spending will increase it. When a boom in trade is in sight it may be desirable to encourage saving in order to reduce the rising tide of current consumption and when a depression is near at hand, it may be desirable to bring about an inflation of consumption by adopting devices that would encourage spending. A very large saving may lead ultimately to a creation of capital and an increase in the National Dividend, but it is certain that current activities in industry will suffer if the rate of saving suddenly begins to increase. Saving, however, is necessary for the growth of capital and for maintaining the capital intact. The real solution comes when the rate of new saving equals the rate of new investments in business.

### 2. Economic services of advertising. (*B. Com., 1932.*)

The most important economic service of advertising is that it makes consumers aware of the existence and utility of an article. New things are constantly coming into the market and consumers are served by producers from long

distances. There would have been no contact between the producers' wares and the buyers' needs if advertising had not been so widespread as it is today. Advertising increases consumption and sometimes makes competition more alert and keen. Besides we have to note that a large number of persons today earn their livelihood because of the expenditure of huge sums of money on advertisements, designers, commercial artists, copywriters, newspaper men and a host of others depend on the advertisers' expenditure for popularising their articles.

### 3 Drawbacks of the present economic system (*B Com.*, 1929)

From the standpoint of the labourers it may be pointed out that the present economic system has brought the monotony, dullness and social evils almost inevitably connected with large scale production. The producer is now a days very often sacrificed to the product.

The consumers' grievances are also manifold. They cannot often buy what they want to buy. The makers and the dealers try to sell what they have got, and individual consumers' demands often go unsatisfied. The prices they pay are loaded with payments to a series of middlemen. Monopolies often grow up and charge high prices. Consumers having no money to offer cannot get satisfaction of their wants.

From the social standpoint the greatest drawback is the conflict between labour and capital, coming as a reaction against the domination secured by the capitalists. The scheme of socialism is only an expression of this reaction.

#### 4. Different types of unemployment. (*B. A., 1942.*)

Unemployment in a modern community may be due to different causes, and it is possible to distinguish types of unemployment on this basis. The three most common types of unemployment are : technological unemployment, seasonal unemployment and cyclical unemployment.

Technological unemployment comes on account of changes in the technique of production. The invention of a new machine or the improvement of an old one may throw some labourers out of employment. Even a new scheme of management may reduce the number of labourers required and cause unemployment. The effects of technological changes on employment are not however permanent. While some labourers are thrown out of employment, new lines of employment are created for others.

Seasonal unemployment comes on account of climatic changes or changes in fashions and tastes. An especially warm winter may reduce the demand for coal and cause unemployment among miners; a continued dry weather may reduce the demand for umbrellas. The most important case of seasonal unemployment is of course found in agriculture. Large numbers of men are required in the ploughing, sowing and harvesting seasons; during the rest of the year, these agricultural labourers remain unemployed. It is however possible to even out the distribution of work in many occupations, and to provide supplementary occupation in agricultural regions.

Cyclical unemployment is the most obstinate problem of our times. The volume of unemployment varies with the phases of the trade cycle, increasing when a boom is in sight

THIS BOOK MUST BE RETURNED ON  
BEFORE THE DATE LAST

292

ESSENTIALS OF GENERAL ECONOMICS

and falling crescendo when a depression is looming large. It is difficult to control cyclical unemployment during a depression unless the whole mechanism of public works, bank rate policy, tax adjustments etc. is brought into operation.

Some help in all these cases may be had from measures to cause a greater mobility of labour, establishment of public employment offices, introduction of flexible wage rates and adoption of all possible steps for stabilising the aggregate demand for labour and the total consumption expenditure of the community.

---